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REPORT

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PERSPECTIVES ON THE PACIFIC COMMUNITY

Summary

Developed nations have become more interested over the last two decades in the nations surrounding the rim of the Pacific Ocean as these countries have come to play an increasingly important role in international trade, politics and security. As U.S. trade with Pacific nations rose beyond the levels recorded in trade with the European Community, interest in the notion of facilitating regional economic and possibly political ties heightened and a growing number of analysts spoke of the "Age of the Pacific."

In practical terms, however, the nations of the Pacific have been unable to promote comprehensive economic policies to enhance the development of economic relations. Political cooperation is also limited and proposals to increase contacts on this front often are controversial because of differing perceptions of political needs and realities. Grandiose rhetoric about the "Age of the Pacific" may have some basis in trade patterns, but more formal structures embodying this concept are far from reality.

What is the Pacific Basin?

A popular book several years ago had academic and policy circles buzzing with its argument that inherent economic and cultural conditions offered a favorable climate for several Asian nations to repeat Japan's economic success and establish a considerable presence, if not dominance, in markets around the globe. With consistently high growth rates for several years, relatively cheap labor, favorable transportation costs, political stability and a work ethic that was conducive to rapid development, the authors insisted that the future was in Asia and particularly in those nations on the rim of the Pacific.

In its broadest sense, the Pacific Basin means those countries whose shores touch the Pacific Ocean. But in practical terms, the expression generally refers to slightly more than a dozen key countries with strong Asian ties, including the United States, Canada, Japan and the northeast Asian countries, the member states of the Association of Southeast Asian Nations, Australia, New Zealand and various territories and small, independent island nations in the Pacific. While the expression Pacific Basin implies an already-established concept, in fact, many pan-Pacific proponents have called for the establishment of a Pacific Economic Community -- duplicating the Common Market arrangement of Europe.

In many of the Pacific Basin nations, growth rates registered nearly double-digit increases for decades until the recession of the early 1980s. In the ten years from 1960, Hong Kong's annual increase in real gross domestic product averaged 10 percent. Between 1970 and 1982 it slid only slightly, to 9.9 percent. Rates for the same period in Malaysia, Singapore and the Republic of Korea reached 7.7 percent, 8.5 percent and 8.6 percent, respectively, compared with a 4.6 percent inflation-adjusted growth rate in Japan and only 2.7 percent in the United States. For the last eight years, economic growth rates in the region have been faster than those in North America and in the European Community.

To a certain degree, formal integration of the countries in the area makes sense, since most nations share common economic concerns. Access to and preservation of natural resources is a high priority since this translates directly into economic prosperity for both sellers and consumers. Development of new renewable resources holds similar importance in policymaking circles, with implications for both importing and exporting nations. With increasing manufacturing investment in the region, technology transfers have assumed greater importance to the Pacific rim countries, while joint discussions of industrial policies have assumed a significant role, particularly in light of Western concern over loss of markets to Asian competitors.

ASEAN is the most visible example of the potential of larger economic alliances. While less than a quarter of ASEAN's total trade is among member nations, the bulk of its overall trade is with Pacific Basin countries. The regional group has been credited with stimulating these exchanges and expanding total trade, while strengthening the individual member states' competitiveness with non-ASEAN countries, particularly the industrialized nations of the West and Japan. Supporters of a Pacific Economic Community note that 54 percent of the combined exports of the area's dozen or so major nations and 59 percent of their imports are with one another, indicating well-developed trade patterns in terms of volume, although not necessarily in a mix that is satisfactory to all partners. In any case, they argue, binding these relationships in an encompassing structure would facilitates these trends and increase regional leverage with other economic groups.

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American Interests

In response to policy moves in Asian capitals, and after discussions with then Prime Minister Masayoshi Ohira of Japan, Sen. John Glenn's (D, Ohio) subcommittee on East Asian and Pacific affairs published an exploratory paper by Hugh Patrick, then of Yale University, and Peter Drysdale, of the Australia National University, dealing with the concept of an integrated Pacific community. The 1979 report proposed forming the Organization for Pacific Trade and Development -- a Pacific counterpart to the Organization for Economic Cooperation and Development but without its large and formal staffing arrangements. The discussion at the time was framed largely in terms of American exploitation of growing markets in Asia. OPTAD was seen in part not only as a means to preserve competitive positions abroad but to enhance them. A further motivation underlying the study was to facilitate development of mechanisms to assess the increasing impact of policies of Pacific Basin countries on one another.

Former Rep. Lester Wolff (D, N.Y.) subsequently joined the congressional bandwagon, proposing a Pan-Pacific Community Association -- a study group of sorts that would analyze common interests and concerns with the intention of drafting recommended policy options for individual countries. Progress on both fronts was stymied somewhat by disagreements between Sen. Glenn and Rep. Wolff. Sen. Glenn was leery of formal structures, while Rep. Wolff's approach was criticized as indistinct.

American interest in the Pacific accelerated when political differences between the Reagan administration and European allies seemed to highlight a more fundamental drift. Washington policymakers began speaking of the shift to the West Coast and beyond, not only of economic power but also political influence. The widely publicized remarks of former Under Secretary of State Lawrence Eagleberger in January 1984 represented this thinking. Eagleberger described his perception of a "shift of the center of gravity of U.S. foreign policy from the transatlantic relationship toward the Pacific Basin and particularly Japan," raising concern in European capitals that the United States was about to abandon traditional ties for a new relationship with its Pacific partners. Although administration officials tried to calm that storm, these were indications that, at the very least, serious attention would continue to focus on this group of nations. A subsequent reference by Secretary of State George Shultz to a "Pacific Community" raised eyebrows and encouraged speculation in Asia that the administration was about to embark on a serious campaign to encourage a formal grouping.

American interest in the Pacific cannot be denied. Cultural ties are relatively strong, particularly through Asian emigration to the West Coast. This country's historic fascination with the region has been replaced by more concrete evidence of Asia's importance. For the last five years, the value of U.S.-Pacific trade has exceeded U.S. trade with any other region, including Western Europe. ASEAN is this country's fifth-largest trading partner and the Japanese trade relationship, while second to trade with Canada, dominates policy concerns in Washington.

The Japanese Role

Japanese attitudes toward the Pacific Basin have both paralleled and in some cases predated U.S. observations on the issue. In 1968, then Foreign Minister Takeo Miki urged formal consideration of policy initiatives that would facilitate increased ties between Japan and other Basin countries. His political rival, Masayoshi Ohira, opted for serious study of similar issues when he took office in 1978. The Pacific Basin Cooperation Concept was an attempt to outline an economic cooperation effort with then Prime Minister Malcolm Fraser of Australia. A September 1980 conference organized in part by the group at the Australia National University was attended by business leaders, academics and government officials from 15 countries.

Mr. Ohira's death in 1980 curbed the momentum behind a pan-Pacific union, but Prime Minister Zenko Suzuki reactivated the concept in a 1982 speech titled "The Coming of the Pacific Age." Faced with increasing ASEAN skepticism -- the group feared being absorbed by a larger organization -- and the less-than-successful administration of the Suzuki era, discussion on cooperation came to a halt.

Because of these difficulties and more important foreign policy priorities, Prime Minister Yasuhiro Nakasone waited until July 1984 to broach the Pacific Basin discussion. A preliminary, tentative gesture toward regional cooperation was offered by Foreign Minister Shintaro Abe in the area of human resource development. The Japanese government indicated its willingness to help meet manpower requirements by providing education and training for Asian business, industry and government leaders.

The prime minister delivered a speech in January 1985 in Australia, outlining Japan's policy on Pacific Basin discussions. He said the talks must be limited to economic, cultural and technological cooperation, with security issues left to other forums. The speech emphasized private-sector initiatives and broached the possibility that other interested nations be allowed to participate in discussions and activities. Mr. Nakasone noted that the superpowers should respect individual initiatives, particularly those undertaken by the ASEAN Ministerial Conference, with the "dialogue partners" -- the United States, Canada, Japan, Australia and New Zealand.

This approach -- which rejects visible Japanese leadership in favor of quiet, behind-the-scenes cooperation and discussion -- continues to reflect Tokyo's position and is likely to remain its policy regardless of possible changes in administration. Japan's importance to any Pacific Basin initiative is obvious. It is the most highly developed economy in Asia and is increasingly assuming greater global responsibilities. Japanese economic growth has helped stimulate Pacific-wide growth through investment and demand for resources. There is a high degree of complementarity between Japan and the other economies in the region, and development assistance progams will expand Japanese interests in the region. Without Japan's cooperation and participation, the movement could create more problems than it solves, but all the potential members agree that Japanese dominance of such an organization is to be avoided.

Pan-Pacific Organizations

Several organizations have been established over the years to facilitate discussions on regional cooperation and in some instances stimulate progress toward the formation of a Pacific Economic Community. Included are:

- Pacific Basin Economic Council (PBEC) - Established in 1968, its founding members included businessmen from Australia, Canada, Japan, New Zealand and the United States. The membership has grown from a handful of member companies to more than 800 firms, including representatives from Korea and Taiwan. PBEC has supported training programs for managers and technicians in less developed countries, and is generally credited with increasing awareness of Pacific trade opportunities among business leaders.

- Pacific Trade and Development Conference (PAFTAD) - Started in 1968, the principal members are Canada, the United States, Japan and Australia. The group has met 14 times since its first seminar in Tokyo. Its members are mainly academics with economic backgrounds. PAFTAD promotes policy-oriented academic studies of Pacific economic issues.

- Pacific Economic Cooperation Conference (PECC) - This is the newest group, established in 1980 by ASEAN, the five industrialized Pacific nations, Korea and a few small Pacific states. PECC's function is to bridge the gap between PBEC and PAFTAD, and meetings occasionally have led to broader cooperation.

- Economic and Social Commission for Asia and the Pacific (ESCAP) - A commission of the United Nations, ESCAP was established in 1947 to facilitate economic and social development in Asia and the Pacific. Formerly titled the Economic Commission for Asia and the Far East (ESCAFE), it was a starting point in the move to establish the Asian Development Bank. Unfortunately for Pacific Basin enthusiasts, most observers consider ESCAP an example of everything that is wrong with the United Nations.

Impediments to Greater Cooperation

Yet for all these positive factors, serious impediments remain that thwart the dreams of Pacific futurists of developing a formally integrated economic and possibly political structure encompassing these diverse nations. Upon examination, many of the problems are understandable. The first is clearly the diversity of the region. The nations of the Pacific Basin represent a wide variety of cultures that inhibits cooperation rather than facilitates it. Religious and cultural differences have plagued relationships among and within many of these countries for centuries. Strong suspicion of Chinese immigrants is conspicuous in many Southeast Asian nations, for example, and linguistic and cultural disputes are commonplace. Cultural repression has been cited frequently as a major cause for continuing strife in the Philippines.

The absence of compatible goals is a fundamental problem facing the region. Some countries would prefer that a formal grouping be restricted to economic cooperation, while others insist on broader political ties. On the surface, this may appear to be a trivial point, but conflicts of interest can be keen when considering policies toward the People's Republic of China, for example.

Involvement by the non-market economies on both economic and security grounds is a major stumbling point. Although the market economy countries would certainly welcome greater sales opportunities in China and other non-market countries, they may be less willing to give imports from such countries any more advantages than they already have. Inclusion in a Pacific Community may not be desirable, given the political cast of these nations and the perceived threats they pose to the region.

Even limiting a formal structure to economic goals among market economies does not necessarily assure success since nations with consistent trade deficits are likely to be hesitant about any arrangement that will make it easier for other nations to penetrate their markets. On the other hand, surplus countries will look for opportunities to increase exports. This conflict could worsen already serious trade problems, particularly with the United States, the largest overseas market for key members of the Pacific Basin.

A number of nations are fearful of being drawn into strategic plans developed by dominant nations in the Pacific, including the United States. In some instances, countries are afraid of cooperating with policies that will commit them to actions that may not be in their best interests or that will bring them into a confrontation with other major powers, such as the Soviet Union. In other cases, the concern is that Asia could become the battleground for a superpower conflict. This clash between strict neutrality and alliance is exemplified by New Zealand's threat to withdraw from the ANZUS alliance with Australia and the United States rather than permit nuclear-capable U.S. vessels to call at its ports. This anti-nuclear position has broader security implications, but in this instance it demonstrates a sensitivity to security issues by these nations and is an element that inhibits broader cooperation.

Security concerns are legitimate and widespread. All the nations in the area, for example, share a common interest in preserving open passage on the high seas and particularly through critical sealanes. The problem, however, comes in defining the best means of keeping them open, the perceived threats to free passage, and the implications of a joint security organization established on top of an economic promotion group.

Political stability -- or the lack of it -- in certain key countries may hinder or help solidarity in the region. The Philippines stands out as an example of a regime that is a cause of concern among its allies. The potential disruptive effects of a violent change in government are difficult to ascertain, but they are not likely to be positive. Concerns over internal security in the Philippines restrict Manila's potential contribution to greater economic unity and even rule out its political participation.

Another obstacle to unrestricted cooperation is the fear among smaller countries of domination by the larger economic powers. Given the present situation, they are concerned about becoming no more than export markets and resource suppliers for Japan, for example. Similar concerns exist vis-a-vis the United States, but the implications are particularly potent in Japan's case in view of its attempts, however unsuccessful, in earlier years to establish the Greater East Asian Co-Prosperity Sphere.

Two practical considerations impede further economic cooperation. The first reality is that other sets of bilateral or trilateral relationships may take precedence over concerns for greater unity. The U.S.-Japan trade relationship, for example, accounts for the lion's share of total Pacific Basin trade. Any dispute between the two countries overrides a concern about Pacific trade. The strong pro-West leanings of the Nakasone government make this country Tokyo's number-one priority in policymaking considerations. Although the style of Japanese diplomacy may change under future leaders, the inclination will probably not. Japan has identified itself first as a member of the Western alliance and second as a Pacific nation. A pan-Pacific organization with anything less than Japan's 100 percent attention is unlikely to succeed. There are similar limitations to participation set by other bilateral relationships.

Perhaps the most serious threat to nurturing the still-fragile Basin concept, however, is the growing protectionist sentiment in the United States. Any limits on the exports of these nations would cause irreparable damage to their long-term economic hopes. A significant statistic cited by Pacific Basin enthusiasts makes this point clear: fully 70 percent of all developing country exports are from the newly industrialized nations of Asia.

Many measures now pending in Congress would affect the Pacific Basin directly and could result in reduced economic growth rates and increased political frictions. The issue is particularly sensitive since these nations produce a considerable amount of American imports across a broad range of industries -- from textiles to telecommunications equipment. Furthermore, the political spillover from the protectionist tide could also damage, if not poison, future efforts at serious cooperation.

Conclusion

There is no doubt that to a certain extent the Pacific Basin is more than just a blurry concept. Trade among the nations of Asia and the Pacific has been growing, despite occasional setbacks, and should continue upward if political disputes can be resolved. Whether total trade volume exceeds that among the Atlantic nations is unimportant. What does count is that all nations continue to prosper and that this success lead to greater global security.

This is particularly significant in Japan's case since it is a natural leader in the Pacific if it maintains its low profile. Japan has economic resources that Asia can utilize and offers a potential new market for Asian and Pacific exports of manufactured goods as well as raw materials. Tokyo's leadership role is expanding because of its economic power, and that can enhance the credibility of a new organization or at least increase the leverage of the Asian market economies. Japan's interest and participation so far has been encouraging to many observers because it indicates the country's willingness to provide leadership in Asia while remaining sensitive to regional concerns. Tokyo has not dictated or imposed a Japanese imprint on pan-Pacific proposals and its future involvement is more likely to be enlightened than heavy-handed.

At this point, however, the Pacific Economic Community is little more than an interesting but cumbersome concept. Examples of cooperation in aid and other areas used by PEC proponents to urge the establishment of a formal bureaucratic structure are not the results of pan-Pacific consciousness, but the sensible and pragmatic considerations of policymakers in individual countries who have defined their political and strategic priorities. It is this concern that will result in greater Pacific cooperation, but not all nations will be -- or should be -- involved, particularly in a formal setting.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Pacific Basin Population Growth Rates, 1980-83

(average annual percentage increase)

Country	Rate	Country	Rate
United States	0.9%	Philippines	2.6%
Canada	1.2	Korea	1.6
Japan	0.7	Hong Kong	1.8
Australia	1.5	Thailand	2.1
New Zealand	1.0	Malaysia	2.3
		Singapore	1.2
		Indonesia	1.8

Source: United Nations, Statistical Yearbook 1983

Table 2: Economic Growth Rates of Pacific Basin Countries, 1960-82

(average annual growth of real GDP)

Country	1960-70	1970-82
United States	4.3%	2.7%
Canada	5.6	3.4
Japan	10.4	4.6
Australia	5.6	3.1
New Zealand	3.6	1.8
Philippines	5.1	6.0
Korea	8.6	8.6
Hong Kong	10.0	9.9
Thailand	8.4	7.1
Malaysia	6.5	7.7
Singapore	8.8	8.5
Indonesia	3.9	7.7

Source: United Nations, Statistical Yearbook 1983

Table 3: Unemployment in Pacific Basin Countries, 1982

Country	Rate
United States	9.7%
Canada	11.0
Japan	2.4
Australia	7.1
Philippines	5.3
Korea	4.4
Hong Kong	3.8
Thailand	0.8 (1980)
Singapore	2.6

Source: United Nations, Statistical Yearbook 1983

Table 4: U.S. Pacific Basin Trade

(in billions of dollars, exports f.a.s./imports Customs value)

	1980	1981	1982	1983	1984
Canada					
Exports	$35.4	$39.6	$33.7	$38.2	$46.5
Imports	41.5	46.4	46.5	52.1	66.5
Japan					
Exports	20.8	21.8	21.0	21.9	23.6
Imports	30.7	37.6	37.7	41.2	57.1
Australia					
Exports	4.1	5.2	4.5	4.0	4.8
Imports	2.5	2.5	2.3	2.2	2.7
New Zealand					
Exports	0.6	0.9	0.9	0.6	0.7
Imports	0.7	0.7	0.8	0.7	0.8
Philippines					
Exports	2.0	1.8	1.9	1.8	1.8
Imports	1.7	2.0	1.8	2.0	2.4
Korea					
Exports	4.7	5.1	5.5	5.9	6.0
Imports	4.2	5.1	5.6	7.2	9.4
Taiwan					
Exports	4.3	4.3	4.4	4.7	5.0
Imports	6.9	8.1	8.9	11.2	14.8
Hong Kong					
Exports	2.7	2.6	2.5	2.6	3.1
Imports	4.7	5.4	5.5	6.4	8.3
Thailand					
Exports	1.3	1.2	0.9	1.1	1.1
Imports	0.8	1.0	0.9	1.0	1.3
Malaysia					
Exports	1.3	1.5	1.7	1.7	1.9
Imports	2.6	2.2	1.9	2.1	2.7
Singapore					
Exports	3.0	3.0	3.2	3.8	3.7
Imports	1.9	2.2	2.2	2.9	4.0
Indonesia					
Exports	1.6	1.3	2.0	1.5	1.2
Imports	5.2	6.0	4.2	5.3	5.5

Source: U.S. Department of Commerce, Highlights of U.S. Export and Import Trade (FT 990)

Table 5: Japan's Pacific Basin Trade

(in billions of dollars, exports f.o.b/imports c.i.f.)

	1980	1981	1982	1983	1984
United States					
Exports	$31.4	$38.6	$36.3	$42.8	$59.9
Imports	24.4	25.3	24.2	24.7	26.9
Canada					
Exports	2.4	3.4	2.9	3.6	4.3
Imports	4.7	4.5	4.4	4.4	5.0
Australia					
Exports	3.4	4.8	4.6	4.3	5.2
Imports	7.0	7.4	7.0	6.6	7.3
New Zealand					
Exports	0.7	0.9	0.9	1.0	1.2
Imports	0.8	0.9	0.9	0.9	0.9
Philippines					
Exports	1.7	1.9	1.8	1.7	1.1
Imports	2.0	1.7	1.6	1.3	1.4
Korea					
Exports	5.4	5.7	4.9	6.0	7.2
Imports	3.0	3.4	3.3	3.4	4.2
Taiwan					
Exports	5.2	5.4	4.3	5.1	6.0
Imports	2.3	2.5	2.4	2.6	3.2
Hong Kong					
Exports	4.8	5.3	4.7	5.3	6.6
Imports	0.6	0.7	0.6	0.7	0.8
Thailand					
Exports	1.9	2.3	1.9	2.5	2.4
Imports	1.1	1.1	1.0	1.0	1.0
Malaysia					
Exports	2.1	2.4	2.5	2.8	2.9
Imports	3.5	2.9	3.0	3.1	4.4
Singapore					
Exports	3.9	4.5	4.4	4.5	4.6
Imports	1.5	1.9	1.8	1.5	1.8
Indonesia					
Exports	3.5	4.1	4.3	3.6	3.1
Imports	13.2	13.3	12.0	10.4	11.2

Source: Japan Tariff Association, The Summary Report: Trade of Japan

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REPORT

NO. 43A

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JAPAN'S SERVICE INDUSTRY AND SERVICE TRADE: AN OVERVIEW

Summary

Since JEI last looked at Japan's service sector (JEI Report No. 45A, November 19, 1982) and service trade (JEI Report No. 43, November 13, 1981), the Japanese economy has clearly made the transition to the post-industrial stage of economic development. Japanese policymakers, however, see the trend against a background of shifting social and even spiritual conditions and they have coined a new phrase to describe it: softnomization.

Because individual service industries have been examined in depth in the two previous reports, this study will only touch on major trends and developments since 1980. In addition, it will examine the revolution that is under way in Japan's trade in services and describe the problems of accurately estimating the volume and value of service trade flows.

Introduction

While the debate over the consequences of entering the post-industrial stage of economic development has been raging in the United States for more than a decade, it is still new in Japan. If it is interpreted to mean the substitution of services for manufacturing as the engine of economic growth, the Japanese economy has been in transition since the early 1970s. The share of gross domestic product produced by the tertiary (service) sector was already 57.2 percent in 1970. (If one excludes government services, the tertiary sector topped the 50 percent mark a few years later.) In terms of employment, 53.2 percent of all workers held service sector jobs in 1970, or if the government sector is omitted, more than half of the labor force held non-manufacturing or non-primary industry (agriculture, forestry, fishing and mining) jobs by 1975.

The move away from manufacturing into services is a logical evolution. As a resource-poor nation, Japan's existence depends entirely on the value added in the production process. The Japanese economy has concentrated on the production of manufactures for expansion, and still does so with great success today. The next step is to focus on services rather than goods. The computer revolution has given a powerful boost to this evolution. Information is recognized as the key to Japan's future prosperity and the information industry is probably the fastest growing sector of the economy. Although this process is rooted in economic factors, social changes have been important in its rapid growth.

Compared with the decade immediately after World War II, Japanese society in the 1980s is rich in material possessions. The percentage of people owning homes, modern kitchen and entertainment appliances, recreational equipment and automobiles is so high as to warrant the word "miracle" when describing the country's economic reconstruction. Having achieved this abundance, the Japanese are beginning to focus on the quality of life. Since this change puts a premium on health, convenience, leisure, and even fashion, the development of the service sector takes on new importance.

A demographic change is also at work. Women used to figure as transients in the labor force; the percentage of women in the job market increased and decreased as the business cycle rose and fell. Currently, however, the proportion of working women is more stable. According to surveys, close to a majority of Japanese women would like to work. Moreover, while women who could not find employment in the past tended to stop job-hunting and accordingly disappeared from the employment statistics, an increasing number now choose to stay in the pool of active job seekers. This has pushed the unemployment rate up to relatively high levels that are insensitive to economic prosperity. As a major employer of women, the service sector's rapid growth has helped to obscure this fact until recently. Actually, women hold the majority of positions in the service industry, a unique situation compared with the rest of the economy.

Most recently, a switch in government policy has given new impetus to the expansion of the service sector. Tokyo's traditionally heavy economic hand has begun to loosen. Under the guise of administrative reform -- streamlining the government to improve efficiency -- significant moves toward deregulation have been made in key markets, including finance and telecommunications. By subjecting these markets to new levels of competitive pressure, existing companies are being forced to improve their services and startup ventures are offering entirely new services. Particularly in the domestic telecommunications market, the surrender of the government's monopoly has opened up new horizons of entrepreneurial endeavor for small and large companies alike. If the policy of deregulation continues to expand, the economic impact will be massive.

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The structural changes that underpin the switch to the service sector are therefore economic, social and political. The consequences of such an immense adjustment are just beginning to be felt, and there is now increasing recognition that Japan does not have good statistics to use as a guide.

The Service Sector vs. Service Industries

In the previous discussion, the service, or tertiary, sector included all economic activities except agriculture, forestry, fisheries and mining (the primary sector), or manufacturing (the secondary sector). This approach is clearly too broad since it includes the provision of public and private services as well as industries such as construction, utilities, real estate, publishing and printing. For the purposes of this analysis, therefore, these industries and public services will be omitted.

"Softnomics," according to a Ministry of Finance advisory panel that proposed the term, is the adaptation of economic management to changing socio-economic conditions. Although this is not a new idea, the degree of emphasis placed on non-material and labor inputs and intangible factors appears to be much greater. In order to truly grasp its implications and development, however, "a revision of the existing statistical and industrial classifications," as well as the "reassessment of the meaning of GNP and the role of government," are required. The advisory panel suggests two measures to calculate the degree of softnomization in each industry: non-material inputs divided by material plus non-material inputs yields Soft Ratio A; and non-material inputs plus labor inputs divided by total production costs gives Soft Ratio B. Non-material inputs include a wide range of costs: wholesaling and retailing, business services, food services, transport, commissions, and so on.

Although there are some measurement problems, the Ministry of Finance calculated Soft Ratio A for every industry from 1965 to 1980 to illustrate that non-material input ratios are increasing in nearly every industry. Furthermore, according to MOF, industries with a Soft Ratio B of greater than 60 percent accounted for over 31 percent of all industries in 1980, up strongly from 1970's 11 percent level. The economic revolution is more complex, however, than these simple ratios indicate.

Prominent Features of the Service Revolution

The explosion of demand for information created fissures throughout the economy, allowing the service revolution to permeate all areas of economic life. Information is the key to more efficient manufacturing, distribution, marketing and financial management. Providing this information as well as supplying the equipment to collect, store, analyze and transmit it has proven to be very fertile ground for service companies. Once dominated by the large electronics manufacturers, the information industry has attracted a host of small businesses offering innovative products. Beyond the direct impact that information and information equipment may have on a firm's primary line of business, it often opens new business opportunities. For example, small regional banks, after pooling their resources to install an automated teller machine network to match those offered by larger competitors, decided to use this new network to start a mail order business targeted at their depositors.

Further incentives emerged as a result of the redistribution of disposable income between consumer durables and services. The material affluence of the average Japanese consumer has meant that an increasing amount of income can be spent on leisure activities, education, or personal services. As in the United States, Japanese consumers are putting greater emphasis on convenience and physical and mental health, leading to the development of a whole range of new service industries.

Services aimed at women are related to this affluence. Working and non-working women today demand services that were once luxuries: cosmetic surgery, exercise classes, art classes, individual design services, domestic services and numerous leisure activities. Increasing numbers of women are also consuming non-traditional services, such as relaxing at liquor or coffee bars with co-workers or friends. With these points in mind, an industry-by-industry overview is more informative.

Industry Cameos

Transportation - Sea and air transport services are presently regulated by the government and thus have not participated fully in the general service boom. In addition to being hobbled by a global glut of capacity, Japanese shipping firms are experiencing new pressures from foreign competitors. One innovation with which they will have to cope is a global information system recently installed by an American shipping company to provide detailed and immediate information on the status and cost of shipments, as well as shipping schedules and availability.

Japan's air transportation industry may be on the verge of a shake-up because the government is considering deregulating both passenger and cargo operations. Although the level of competition among Japanese carriers is intense, it is not the all-out war that characterizes the U.S. industry. There are no Japanese equivalents to this country's low-cost, no-frills airlines, and no "frequent flyer" bonus plans, except for Japan Air Lines Co., Ltd.'s, which is aimed at international passengers.

Nevertheless, in order to keep abreast of developments, Japanese air carriers are considering a number of improvements in non-material inputs. An important one is the extension of integrated information management to maintenance activities. Several U.S. airlines already have installed computerized maintenance programs that have yielded appreciable reductions in cost and improvements in service. It is almost certain that this type of system will be adopted throughout the industry.

Land transport has undergone a significant structural change, mainly as a result of deregulation. Overnight and door-to-door delivery services have prospered since the government allowed them to compete with the postal service. Because facsimile machines are nearly universal in Japanese offices, delivery companies have concentrated on serving households. Just as in the United States, the degree of competition is intense. One innovation Japanese firms have developed is the use of numerous small retail stores as regular pick-up points, which saves the companies money while providing convenient facilities to customers.

Distribution - Because of the effects of government regulation, the distribution sector has been unevenly affected by the "softening" of the economy. Current laws give existing small retail stores a major say in whether a retail outlet of a specific size or larger can be established in their neighborhood. Japan's distribution network is widely criticized as outmoded and inefficient, but where there is freedom to change, companies in this industry have moved aggressively.

The information revolution has had a strong impact on this sector. Utilizing point-of-sale terminals, retailers and wholesalers can more accurately track consumer tastes and preferences, allowing them to respond properly and in a timely fashion to changing demand. Integrated data and communications networks are also improving the efficiency of the distribution system by linking manufacturers, wholesalers and retailers.

The most important change has been the industry-wide introduction of mail ordering. Traditional mail order houses have suffered from a poor image until recently. By improving after-sales service and instituting stricter quality requirements, these companies have significantly improved their standing with consumers. Many mail order firms are now making the move into electronic networks, which promise new levels of convenience. Large and small retailers are fighting back with electronic networks of their own. The business has proved so attractive that concerns that have nothing to do with retailing, including the regional banks cited earlier, for example, are diversifying into mail order operations. If the national integrated telephone, video and data network proposed by Nippon Telegraph and Telephone Corp. becomes a reality, the distribution industry will be fundamentally altered.

Financial Services - This sector has been shaken from top to bottom in recent years by government deregulation. Given Japan's high personal savings rate, profitable corporations, significant private pension programs, and maturing equity markets, financial markets have grown significantly. Until recently, however, the market lacked sophistication in terms of instruments available and services offered. Coinciding with strong pressure from domestic financial institutions, the yen-dollar agreement between Tokyo and Washington threw the deregulation process into forward gear. As the restrictions have fallen one by one, the competition between banks, securities companies and other financial institutions has intensified.

Brokerage services now offer Japanese investors 24-hour trading, at-home trading, and discount services on a broader selection of instruments. With better access to European money markets, Japanese securities firms have set their sights on a larger share of international financial transactions. Riding the tidal wave of funds flowing out of the country, securities firms have armed themselves with fully electronic trading systems and state-of-the-art computer equipment as they prepare for tougher international as well as domestic competition.

Japanese banks have been racing neck-and-neck with securities firms to offer customers a full range of financial services. Although Japanese law prohibits direct competition between banks and securities houses in their main lines of business, companies have been locked in a battle of one-upmanship to offer innovative financial instruments. Bankers are selling electronic banking, home banking, banking-related facilities and even unrelated services in an effort to win and keep individual and corporate clients.

The adjustment in consumer credit patterns has been less radical. Largely due to the interest of foreign firms, Japan's consumer credit market is slowly bringing itself up to date. While the number of credit cards issued is rising, laws restricting installment credit have blunted their impact on Japanese spending patterns. The absence of a national credit reference operation continues to make consumer loans highly risky. Until the appropriate regulatory framework and informational supports are in place, the profitability of consumer credit will remain latent.

The insurance industry is also feeling the effects of financial deregulation. Despite the fact that there are more policies outstanding than there are people in Japan, vendors of life and health insurance are also responding to the more competitive environment by broadening ways for policy holders to utilize their equity and by offering higher returns on policies.

Management and consulting - The surge in international economic activity has redounded to the benefit of foreign and domestic management and consulting firms in Japan. Although it is still unusual for a Japanese company to hire outside management (except in times of financial difficulty), firms catering to the needs of foreign companies or small startup concerns have found themselves a comfortable niche. Foreign firms seeking to enter Japan's markets are wise to avail themselves of the expertise Japanese management firms offer. Small Japanese companies, on the other hand, are often interested in exploring overseas markets, but because of their limited resources, may not be willing to undertake their own foreign market research effort. Management consultants can provide the necessary overseas experience while allowing the company to maintain tight control over operations.

Unlike some of the following professional services, the management and consulting industry is mostly free of interference from the government or professional associations. While this might lead to problems with the quality of service offered, it allows for rapid growth and easy access for foreign firms. As cross investment accelerates, the market should provide plenty of room for foreign and domestic advisors.

Advertising - This is an area where Japanese companies are building an impressive global reputation. Japanese trends in advertising parallel those seen in Europe rather than the United States. U.S. advertisements are jammed with information meant to convince the buyer of the product's superiority, either in terms of performance or cachet. Japanese ads generally seek to capture the attention and imagination of the audience and only then do they establish a link with the product. From the American point of view, this approach generates ads that are startling and often humorous, but confusing as to exactly what is being promoted. Whatever the case, advertising has developed into a major industry as Japanese companies in all lines of business encounter stiffer competition.

The potential for foreign firms in Japan or Japanese firms abroad is an open question. The success of advertising is clearly dependent on a thorough understanding of local tastes, preferences and aesthetics. One trip through a major Tokyo department store is enough to convince anyone that the Japanese consumer has a highly developed sense of design and color. On the other hand, markets such as the United States present a diversity of regional attitudes and customs that might bewilder a foreign ad designer. Joint ventures may prove to be the ideal vehicle for international advertisers since they allow exchanges of expertise in respective areas.

Leasing/rental services - The rapid pace of technological change has proven a bounty to the leasing and rental business. The useful lifetimes of modern office, electronic and computer equipment have been radically shortened, making it economic to lease or rent such equipment rather than buy. The development of the industry has followed the U.S. pattern. Leasing firms tied directly to equipment manufacturers operate along with independent companies that may offer a wider range of brands.

Rental companies are also taking the U.S. approach, but with a Japanese twist. Downtown Tokyo rental stores will rent practically anything -- a reflection of space limitations within the metropolis -- and even deliver it to the doorstep and provide advice on its use. Both rental and leasing companies often offer maintenance and repair services, presenting attractive package deals to consumers.

Information services - This sector is truly the muscle behind the service revolution. According to various Japanese studies, the information industry accounts for between 35 percent and 40 percent of gross national product. Although the primary information industry (companies engaged solely in providing information services) has grown steadily to reach an estimated 20 percent of GNP, secondary information services (the labor and capital used by other businesses to provide information services) have grown much faster, moving from practically zero to a size rivaling that of the primary industry. These surprising numbers arise in part from the broad definition of the industry commonly used by researchers. This definition includes all office workers, even secretaries, but does not detract from the overall conclusion that the information industry has been a major source of growth.

The rise of the computer industry gave birth to a host of support services: software writing, training, repair and maintenance. It also made possible several new ones, including database services and data entry services, and revolutionized others, such as graphic design and engineering. As computers have become more powerful and less costly, their influence has spread throughout the economy, from agriculture and manufacturing to entertainment and education. To date, there has been ample room in the industry to accommodate both large and small firms. In general, however, small firms have proven to be more innovative and flexible in fulfilling new needs.

The software industry is an obvious choice for any high growth award. Although many major Japanese equipment manufacturers produced mainframes to run existing U.S. software, the market for smaller computers had no de facto standards. That, combined with the practice of providing customized software to each client, presented vast growth opportunities. More recently, however, the industry has found itself mired in the same slump as U.S. firms, albeit less severely. As the market shrinks, it tends to push firms into direct competition with smaller ones, and industry watchers have been predicting a shakeout.

For a number of reasons, Japan's software industry has yet to pull abreast of its American counterpart (see JEI Report No. 9B, March 8, 1985). While the quality of Japanese programs is praised by foreign experts, the industry has failed to produce innovative programs with mass market potential. It seems likely that the U.S. software industry will enjoy undisputed world dominance for some time to come.

Japanese database services are also undeveloped in comparison to the United States. Whereas a computer user in this country can tap into databases of great depth and breadth at a reasonable cost, the databases available in Japan are often quite narrow in coverage and very expensive to use. There is a movement afoot within the Ministry of International Trade and Industry and private-sector associations to establish additional databases and link them together. Such a program will obviously take a number of years to complete, although the relative absence of these products in the market should attract new companies.

Paralleling the evolution of the industry in the United States, once-flourishing data processing services have fallen on hard times. The rapid cost decline of computing power has made in-house computing facilities the rule today. In response, these firms are now considering entering the value-added network market or are diversifying their operations.

Telecommunications - Deregulation of the domestic telecommunications market could have as broad an impact as the spread of computers. With a large base of computers installed, the next logical step is to link them together. The April 1, 1985 reform of the domestic telecommunications market will help Japan achieve this goal more quickly. Telecommunications services extend beyond data transmission, and areas such as high-capacity voice/video links, local area networks, and secure communications networks are enjoying strong interest.

For the first time, private companies can compete with Nippon Telegraph and Telephone Corp. in the primary voice communications market. There are already five entrants in the head-to-head battle and more are likely to follow (see JEI Report No. 26B, July 12, 1985). Other companies have less ambitious plans: firms offering dedicated voice/data services in specific localities, particularly Tokyo, are testing the waters.

Integrated voice/video/data services for individual households are also on the drawing boards. NTT's Integrated Network System, which offers a variety of services via standard telephone lines, is currently being tested in two small cities. Private companies are also pondering similar services, especially major department stores and distributors.

The hottest area is undoubtedly integrated business communications services. Value-added networks, which allow data to be exchanged between dissimilar computer systems and provide remote processing and storage, are being offered by foreign and domestic companies of all shapes and sizes. VANs for special purposes are proliferating, while behemoths such as IBM Japan Ltd. and NTT are working on a joint VAN that could dominate the mass market. Personal computer owners have not been left out of this revolution -- computer bulletin board services are being installed, and NTT is part of a venture to establish a nationwide personal computer network.

The international communications network is also feeling the shock of deregulation. Kokusai Denshin Denwa Co., Ltd., the public company with a de facto monopoly on international circuits, has struck several bargains with foreign communications firms to provide expanded and less expensive international services. Japanese and American users will soon have access to databases in each other's countries.

Professional services - This broad category has remained a relatively minor industry in terms of value, but not impact. Some of these services, particularly the legal and medical, have been stifled by powerful professional associations and/or limited training. Changes in these industries will be slow and gradual and will not play a significant role in growth or service trade. In fact, they can lead to trade frictions, as in the case of foreign lawyers seeking to practice in Japan (see JEI Report No. 36B, September 20, 1985).

On the other hand, services such as education, engineering, architecture and design are a vital force in economic change and international trade. The Japanese family spends unstintingly on education, spurring the rise of a large number of cram schools, which in turn provide many jobs to women. Japan's engineering, architectural and design expertise is being exported throughout the world, reversing the import dependence of the immediate postwar years.

Environmental services - The Japanese concern over the quality of life is fully expressed in the development of this industry. Companies providing pollution control or waste disposal services have developed technologies to handle industrial waste products. Toxic waste disposal receives much more attention in Japan than it does here, even extending to a debate over whether ordinary disposal of mercury batteries is safe. While the domestic market is not large, the potential for overseas sale of Japanese know-how could be significant. Developing as well as industrialized countries are increasingly concerned with environmental problems.

Personal services - The affluence and changing values of Japanese society are reflected in the explosion of personal services. While entertainment, travel and food services are not new to the Japanese, today's service revolution brings a much wider variety of choices to a far greater number of people. Exercise classes, health spas, art classes, domestic errand services, and a wide range of leisure activities are within the grasp of middle-class citizens. The fact that such businesses often require only part-time work has meant that they can tap the huge reservoir of housewife labor. Although some policymakers have expressed concern that the personal service industry is not good for future economic growth because of relatively low productivity rates, Japanese consumers are quite glad to pay for these quality-of-life improvements, and it is unlikely that such jobs are a drain on the nation's labor resources.

An Overview of Japan's Service Trade

This quick outline of Japan's service sector reveals growing links with overseas markets, an assertion that is born out by balance of payments data. It should also be clear that the balance of payments data do not encompass all of the service industries for a variety of reasons (see JEI Report No. 43, November 13, 1981). First, a number of service industries have little or no involvement with the foreign sector. Second, the statistics do not catch all of the transactions -- the old rule that services are consumed where they are produced has been blurred by the increasing use of international communications networks. These exchanges of information and data are probably the fastest growing component of service trade not captured by existing statistics. Despite these shortcomings, the balance of payments data are one of the few bits of information that we have and it can at least indicate general trends.

Table 1 presents data on Japan's global trade in services, while Table 2 gives the Japan-U.S. picture. The growth of service trade has outpaced the growth of trade in goods, although the latter remains much larger in absolute size. Paradoxically, however, the total value of services in Japan-U.S. trade has actually fallen relative to the total value of goods since 1980. After rising from 46 percent of total goods trade in 1980 to 49 percent in 1982, services dropped to 36 percent in 1984. In absolute terms, services made relatively steady headway throughout the five-year period.

Although Japan's net balance in services remains negative, the gap has been closing since 1980, primarily because of the increasing surplus of investment income. Given the big capital outflow of the past two years, this trend will continue, exacerbating the current account surplus.

From a bilateral viewpoint, Japan's service deficit has behaved erratically over the past five years, but has tended to contract. The categories that have shown the greatest growth are investment income and other private transactions, which include management, patent and other fees. As a general indicator of the flow of technology transfers, patent royalties show that Japan's technology is an increasingly marketable commodity.

Outlook

From the data available, it is clear that Japan's service sector and service trade will play an increasingly important economic role. If planned multilateral talks are successful at reducing barriers to trade in services, Japan will certainly benefit along with the United States. The main task facing government leaders is how to integrate the service revolution into the decision-making framework. Indeed, as the search for sustainable economic growth continues, industrial countries will be forced to devote more of their attention to the service sector.

Data deficiencies are probably the biggest roadblock to a better understanding of the impact and international flows of the service sector. Whereas trade statistics for goods are quite detailed, statistics on services are highly aggregated. There are numerous problems involved in the collection and valuation of data, including how to get companies to report service transactions, how to put a value on them, and even how to separate them into groups. Nevertheless, changes are in motion within the United States and Japan to ameliorate this situation.

The potential for conflict in service trade exists, as illustrated by the current dispute over foreign lawyers in Japan, but is outweighed by the opportunities for cooperation. As the leading information-oriented economies, the United States and Japan are endowed with large markets and high levels of expertise. With both governments moving to deregulate many service industries, businessmen on both sides of the Pacific appear eager to continue the service revolution.

For more information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Japan's Balance of Payments in Services

(in millions of dollars, IMF basis)

	1980			1981			1982			1983			1984		
	Credit	Debit	Net	Credit	Debit	Net	Credit	Debit	Net	Credit	Debit	Net	Credit	Debit	Net
Transportation	$12,991	$17,334	$-4,343	$15,356	$18,516	$-3,160	$13,308	$16,729	$-3,421	$12,221	$15,499	$-3,278	$12,886	$15,917	$-3,031
Freight	7,155	3,770	3,385	8,132	3,446	4,686	7,249	3,371	3,878	6,761	3,501	3,260	7,359	3,812	3,547
Insurance	255	446	-191	259	442	-183	219	408	-189	239	360	-121	290	385	-95
Port fees	3,661	6,652	-2,991	4,792	7,254	-2,462	3,809	6,617	-2,808	3,454	6,253	-2,799	3,659	6,253	-2,816
Passenger fares	524	1,488	-964	548	1,713	-1,165	555	1,711	-1,156	551	1,704	-1,153	536	1,851	-1,315
Charter fees	1,136	4,696	-3,560	1,291	5,324	-4,033	1,106	4,340	-3,234	856	3,406	-2,550	761	3,229	-2,468
Ships	11,168	14,504	-3,336	13,320	15,448	-2,128	11,283	13,709	-2,426	10,075	12,562	-2,487	10,559	12,797	-2,238
Aircraft	1,568	2,384	-816	1,777	2,626	-849	1,806	2,612	-806	1,907	2,577	-670	2,037	2,735	-698
Travel	644	4,593	-3,949	735	4,616	-3,881	754	4,116	-3,362	825	4,428	-3,603	970	4,607	-3,637
Tourists	415	2,653	-2,238	465	2,553	-2,088	493	2,110	-1,617	575	2,310	-1,735	670	2,385	-1,715
Investment income	11,115	10,261	854	15,761	16,524	-763	18,320	16,602	1,718	15,601	12,519	3,082	18,768	14,537	4,231
Direct investment	1,340	531	809	1,440	624	816	1,589	597	992	2,040	686	1,354	2,201	773	1,428
Bond interest	815	500	315	976	592	384	1,268	668	600	1,386	816	570	1,614	1,052	562
Others	6,749	10,654	-3,905	7,931	13,700	-5,769	8,703	13,486	-4,783	8,940	14,247	-5,307	9,530	14,840	-5,310
Official	1,475	264	1,211	1,968	305	1,663	2,339	306	2,033	2,250	317	1,933	2,461	331	2,130
Private	5,274	10,390	-5,116	5,963	13,395	-7,432	6,364	13,180	-6,816	6,690	13,930	-7,240	7,069	14,509	-7,440
Management fees	573	1,190	-617	730	1,487	-757	854	1,708	-854	886	1.793	-907	1,107	1,859	-751
Patent royalties	354	1,328	-974	482	1,712	-1,230	559	1,754	-1,195	569	1,982	-1,413	695	2,274	-1,579
Other fees	2,020	4,147	-2,127	2,001	5,405	-3,404	1,913	4,991	-3,078	1,814	4,444	-2,630	2,027	4,701	-2,674
Advertising	*	504	--	*	491	--	*	536	--	*	553	--	*	629	--
Film rentals	*	105	--	*	79	--	*	76	--	*	145	--	*	105	--
Non-merchandise insurance	57	309	-252	38	280	-242	-28	179	-205	-235	183	-418	-196	277	-473
Total	31,499	42,842	-11,343	39,783	53,356	-13,573	41,085	50,933	-9,848	37,587	46,693	-9,106	42,154	49,901	-7,747

*Included in "Other fees"

Source: Bank of Japan, Balance of Payments Monthly

Table 2: Japan's Service Trade with the United States

(in millions of dollars, IMF basis)

	1980			1981			1982			1983			1984		
	Credit	Debit	Net	Credit	Debit	Net	Credit	Debit	Net	Credit	Debit	Net	Credit	Debit	Net
Transportation	$4,145	$5,725	$-1,580	$4,754	$5,361	$-607	$4,084	$4,817	$-733	$3,870	$4,443	$-573	$4,413	$4,450	$-37
Travel	264	1,787	-1,523	309	1,760	-1,451	302	1,576	-1,274	336	1,655	-1,319	392	1,761	-1,369
Investment income	3,332	2,931	401	4,719	3,936	783	5,940	3,800	2,140	4,282	3,002	1,280	5,023	3,644	1,379
Others	2,919	3,593	-674	3,474	4,432	-958	3,578	4,388	-810	4,074	5,346	-1,272	4,440	5,908	-1,468
Official	1,034	61	973	1,153	93	1,060	1,253	105	1,148	1,416	102	1,314	1,515	118	1,397
Private	1,885	3,532	-1,647	2,3321	4,339	-1,018	2,325	4,283	-1,958	2,658	5,244	-2,586	2,925	5,790	-2,865
Total	10,660	14,036	-3,376	13,256	15,489	-2,233	13,904	14,581	-677	12,562	14,446	-1,884	14,268	15,763	-3,743

Source: Bank of Japan, Balance of Payments Monthly

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Another Look At The Bilateral Trade Imbalance

In a report released October 29, C. Fred Bergsten and William Cline of the Institute for International Economics cite macroeconomic policies as the major cause of the increasing trade imbalance between Japan and the United States. The study, The United States-Japan Economic Problem, states that "the rise in the U.S.-Japanese trade deficit from 1980 to 1984 can be fully explained by changes in the exchange rate and rates of economic growth." The

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It is unclear whether the administration will back legislation already introduced by Sen. Charles Mathias (R, Md.) or generate its own bill. In any event, the development should please Japanese business groups, which view the worldwide unitary method as an impediment to their growing U.S. presence at best and a serious thorn in bilateral relations at worst.

Michael W. Chinworth

Record Japanese Current Account Surplus In FY 1985's First Half

Topping the previous all-time high recorded in FY 1984's first half, Japan's current account set a record $26.6 billion surplus during the first half of the current fiscal year. The trade balance also posted a $29.3 billion semiannual record surplus.

Japan's Selected Foreign Balances

(in millions of dollars)

	FY 1982	FY 1983	FY 1984	April-September 1984	April-September 1985
Current Account	$9,135	$24,232	$37,015	$18,661	$26,597*
Trade Balance	20,141	34,546	45,601	23,148	29,256*
Exports	135,993	150,740	167,858	85,304	86,678*
Imports	115,852	116,194	122,257	62,156	57,422*

*Preliminary

Source: Bank of Japan

Exports climbed to $86.7 billion, 1.6 percent above the previous high recorded in the April-September 1984 half. The 7.2 percent increase in exports to the United States was fueled by increased shipments of cars, trucks and buses, which rose to 1.7 million units, a 300,000-unit increase from the same period a year earlier. At the same time, increased shipments of electronic goods and cars contributed to a doubling of Japan's exports to China. Imports fell 7.6 percent from the same period a year ago, reflecting reduced imports of crude oil and other primary products.

The announcement of Japan's record current account surplus coincided with a sharp rise in the value of the yen from Y214.9=$1.00 on October 24 to Y207.8=$1.00 on November 5, its highest level since March 1981. Traders attributed the strengthening of the yen to higher interest rates in Japan and the announcement of the record U.S. September trade deficit of $15.5 billion. The Bank of Japan is believed to have intervened several times on a small scale last week. The rise in the yen was also encouraged by Bank of Japan governor Satoshi Sumita and Finance Minister Noboru Takeshita, who told the Diet that the yen should appreciate further against the dollar.

In another move designed to strengthen the yen, the Japan Development Bank, a government financial institution, announced that it will raise $200 million by issuing bonds in New York this month. This will be the largest amount of government-guaranteed bonds denominated in dollars ever issued by Japan abroad. The proceeds will be converted into yen and will thus help lower the value of the dollar. When the bank issued $100 million worth of bonds on two occasions last year, the yen appreciated against the dollar.

Randall S. Jones

The Minebea Saga: The Hunter Becomes The Hunted

The most popular drama among businessmen in Japan these days is not on television but on the floor of the Tokyo Stock Exchange. Minebea Co., Ltd., an acquisition-minded Japanese manufacturer of miniature ball bearings, has had the tables turned on it as two foreign companies declared their intention to pursue a hostile takeover bid. The drama confronts the Japanese financial community with a painful reality: If Japanese financial institutions want access to international markets, they have to play by international rules. This point will be brought home with even greater force after foreign securities firms join the Tokyo Stock Exchange as part of a planned membership expansion. Most observers agree that a major change in Japanese attitudes toward corporate mergers and takeovers is in the offing.

Minebea has been somewhat of a dark horse among Japanese companies, primarily because of its philosophy of expansion by takeover. This practice, considered unorthodox in Japan, was tolerated by the business community because the Nagano-based firm only pursued foreign firms or companies facing financial difficulties. An abrupt change in this pattern took place in late August when Minebea sought to buy out a healthy company, Sankyo Seiki Manufacturing Co., Ltd., and was rejected. Minebea's persistance led to a situation unprecedented in postwar history: a hostile takeover bid (see JEI Report No. 34B, September 6, 1985).

In a turn of events that is commonplace in the United States, Minebea then found itself the target of a "greenmail" assault and subsequent takeover tender by two foreign investment firms. Trafalgar Holdings Ltd., a Los Angeles-based holding company, and Glen International Financial Services Co. of Britain announced that they had acquired the rights to approximately 30 percent of Minebea's outstanding shares just as Minebea was announcing its intentions toward Sankyo Seiki. The two firms immediately offered to sell their warrants and convertible bonds back to Minebea, but at a price equivalent to twice the current value of Minebea's shares. Minebea's management disdained this greenmail ploy by seeking the support of the company's other major stockholders, depriving the foreign firms of shareholder support.

This was not the end of the matter, however. Minebea is persisting in its efforts to acquire Sankyo Seiki, while Trafalgar and Glen remain interested in the fast-growing Minebea. This became abundantly clear October 25 when the two partners made an unsolicited bid composed of cash, convertible debentures and U.S. government bonds totalling Y308 billion ($1.4 billion at Y220=$1.00), approximately four times the current market price per share, for all of Minebea's outstanding and reserved stock. The pair threatened to launch a hostile bid if the ball bearing maker refused the offer. Trafalgar scheduled a

STATISTICAL SUPPLEMENT

Trade and Payments Data
(in millions of dollars unless otherwise indicated)

	1983	1984	January-September 1984	January-September 1985	July 1985	August 1985	September 1985
Japan's Balance of Payments							
Trade Balance	$31,454	$44,257	$30,741	$38,193*	$5,414*	$4,380*	$5,269*
Exports (f.o.b.)	145,468	168,290	123,900	124,842*	15,120*	13,707*	14,612*
Imports (f.o.b.)	114,014	124,033	93,159	86,649*	9,706*	9,327*	9,343*
Current Account Balance	20,799	35,003	23,467	33,415*	4,958*	3,494*	4,883*
Long-Term Capital (net)	-17,700	-49,651	-32,545	-46,022*	-8,868*	-6,527*	-3,106*
Overall Balance	5,177	-15,200	-11,655	-9,085	-3,374	-1,881	504
International Reserves (end of period)	24,496	26,313	25,441	27,523	28,103	28,452	27,523
Japan's Customs Clearance Trade							
Trade Balance	20,534	33,611	22,273	30,322*	4,604	3,513	4,547*
Exports (f.o.b.)	146,928	170,114	125,253	126,188*	15,298	13,874	14,752*
Cars	19,535	21,899	16,431	17,845*	2,311	1,835	2,186*
Steel	12,845	13,852	10,085	10,024*	1,177	1,042	1,084*
Imports (c.i.f.)	126,393	136,503	102,981	95,867*	10,694	10,362	10,205*
Crude Oil	40,063	39,379	29,903	25,376*	2,511	2,497	2,602*
Japan-U.S. Trade							
Trade Balance	18,181	33,075	23,494	27,292*	-3,699	3,045	3,776*
Exports (f.o.b.)	42,829	59,937	43,706	46,813*	5,827	5,145	5,655*
Imports (c.i.f.)	24,648	26,862	20,212	19,521*	2,128	2,100	1,879*
Yen-Dollar Exchange Rate							
Tokyo Spot Market (end of period)	Y232.20	Y251.10	---	---	Y236.65	Y237.25	Y217.00
U.S.-Japan Trade							
Trade Balance	-19,289	-33,560	-25,905	-34,218	-3,573	-3,701	-4,526
Exports (f.a.s.)	21,894	23,575	17,417	17,064	1,845	1,743	1,926
Industrial Supplies	8,734	9,139	6,719	6,468	634	660	724
Food and Feed	5,555	5,929	4,578	3,773	508	457	501
Capital Goods	5,116	5,627	4,064	4,490	396	389	401
Consumer Goods	1,394	1,476	1,115	1,093	125	126	105
Imports (Customs)	41,183	57,135	43,322	51,282	5,418	5,444	6,452
Automotive Products	14,919	18,477	14,115	18,197	2,126	2,013	2,315
Capital Goods	11,896	19,290	14,577	16,314	1,669	1,650	2,027
Consumer Goods	8,296	11,266	8,466	10,346	976	1,139	1,340
Industrial Supplies	5,391	7,276	5,543	5,504	537	542	673

*Preliminary

STATISTICAL SUPPLEMENT

Japanese Economic Indicators

(percentage change from year-earlier period unless otherwise indicated)

	1983	1984	January-August 1984	January-August 1985	June 1985	July 1985	August 1985
Discount Rate (end of period)	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Outstanding Money Supply	7.4%	7.8%	7.8%	8.1%	8.2%	8.2%	8.3%
Industrial Production	3.6%	11.1%	11.6%	6.1%	4.8%	6.3%	4.1%
Manufacturing Operating Rate	1.6%	7.3%	8.9%	3.1%	0.6%	2.7%	1.4%
Number of Bankruptcies	11.9%	8.8%	14.3%	-8.9%	-6.3%	-5.2%	-11.8%
Residential Construction Starts	-0.8%	4.4%	4.4%	3.6%*	6.0%	-0.5%	-4.7%*
Job Openings to Applications (ratio)	0.60	0.65	0.64	0.69	0.70	0.68	0.68
Nominal Wages	3.5%	4.5%	4.4%	3.7%	2.0%	3.0%	8.0%
Labor Productivity	4.5%	9.9%	10.6%**	6.1%**	4.7%	n.a.	n.a.
Wholesale Prices	-2.2%	-0.3%	-0.6%	0.0%	-0.2%	-1.2%	-1.6%
Consumer Prices	1.9%	2.2%	2.2%	2.1%	2.5%	2.4%	2.3%
Yen-Based Export Prices	-6.0%	0.6%	-0.3%	2.0%	1.1%	-2.1%	-3.2%
Yen-Based Import Prices	-7.8%	-3.4%	-4.6%	1.1%	0.8%	-2.2%	-4.2%

*Preliminary

**Through June of each year only.

For Japan's most recent GNP figures, see JEI Report No. 38B, October 4, 1985.

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REPORT

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JAPAN'S FOREIGN AID POLICY: 1985 UPDATE

Summary

In 1984 Japan surpassed France to become the second-largest donor of official development assistance (ODA). This achievement occurs at a time of transition in Japan's foreign aid planning. The FY 1981-85 aid doubling plan is projected to narrowly miss its target, but Tokyo has already announced a new seven-year plan to double overseas aid that aims not only at expanding the quantity of Japan's assistance to the developing world but also at improving the quality of that aid.

Although the commitment to expand and support economic development in the developing nations remains strong, discussions about the direction and content of ODA have begun to spread from aid professionals and specialists to a broader group of commentators concerned with Japan's image in the international community. Future programs will be shaped by a variety of factors, among them, Japan's perception of its global leadership role, relations with the United States and domestic budgetary constraints.

Japan's Evolving Aid Policy

Japan's foreign aid policy has evolved over the past 30 years from a position that linked aid to domestic development goals like export promotion and overseas investment to one that takes both humanitarian and political/security considerations into account. Several phases of this evolution may be identified: war reparations from the mid-1950s to 1965; tied aid to promote

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exports, particularly to Southeast Asia, from the mid-1950s through the early 1970s; and an ambitious effort to untie assistance and expand ODA disbursements beginning in the late 1970s that coincided with an emphasis on meeting basic human needs and larger strategic concerns, including economic interdependence and regional stability.

In a study on the subject, aid experts William L. Brooks and Robert M. Orr write that Tokyo's aid program grew directly out of its role as a former colonial power, which partially explains why a consistently high percentage of funding has always gone to the nations of Southeast Asia. Reparations negotiations after World War II provided $500 million to the Philippines and $400 million to Indonesia over a 20-year period, $20 million to Burma for 10 years, special compensation to Thailand, and various tied-aid packages to the nations of Indochina. These outlays totaled a relatively modest $1 billion over 20 years, or less than 2 percent of Japan's national budget during that time.

In the years of economic reconstruction after the war, Japan viewed itself as a developing country and was quite open about its intent to cultivate export markets as well as secure access to raw materials. Throughout the 1960s, when the Japanese economy was growing by 10 percent-plus a year, export credits and private-sector aid continued to make up an estimated 65 percent of total aid flows. In part as a result of international criticism of this heavily tied assistance -- and in view of Japan's rapidly emerging global economic leadership -- Tokyo sought to improve the quality and regional distribution of its aid. During the late 1970s it led other major donors in the untying of assistance. The oil crisis at the beginning of that decade underlined Japan's dependence on external economic developments and prompted Tokyo to reassess its Asian focus. Resources began to flow to countries outside the traditional aid sphere, particularly to the nations of the unstable Middle East.

The most recent development in the evolution of Japan's aid policy began in 1977 with the first ODA-doubling plan. Calls for Japan to fulfill its responsibilities as a world economic power, particularly from the United States, were a major factor in the decision to expand foreign aid so dramatically. Since Tokyo, for constitutional reasons, has concentrated its military spending on self-defense efforts, expanded development assistance is a politically palatable way to take on international duties.

Domestic sentiment also played a constructive role. Unlike the United States, Tokyo's foreign aid programs have widespread and consistent popular support. Along with the "peace diplomacy" aim, national pride became a factor. That Japan's startling economic success serves as a role model for developing nations is a source of satisfaction closely linked to development assistance in the minds of many Japanese. All of these sentiments were codified in the so-called "Fukuda Doctrine" outlined in 1977 by then Prime Minister Takeo Fukuda.

During this period policymakers also began to adopt the concept of comprehensive security. The idea formally emerged in 1980 in a report commissioned by former Prime Minister Masayoshi Ohira, which recommended a

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comprehensive approach to national security based on long-term strategies for defense, energy and food supplies. Events such as Vietnam's invasion of Cambodia in 1979, oil shortages related to the Iranian revolution and the Iran-Iraq war, and Moscow's occupation of Afghanistan added a sense of urgency to the rather vague principles of comprehensive security.

Aid policy since then has blended regional and comprehensive security considerations with the desire to complement U.S. aid policy. Assistance is provided to those countries with high levels of economic interdependence with Japan, such as China and the nations of Southeast Asia; to nations involved in regional conflicts, including Thailand and the Sudan; to countries of strategic importance to the Western alliance and of particular concern to the United States, like Egypt, Turkey and Pakistan; and finally, to areas of great humanitarian concern, notably Bangladesh and the poorer countries of Africa.

Tokyo easily exceeded its first aid-doubling goal between 1977 and 1980, bringing assistance levels to more than $3 billion annually. Grant and technical assistance elements of aid flows increased significantly, although they still fell short of the average achieved by members of the Organization for Economic Cooperation and Development's Development Assistance Committee. ODA as a percentage of Japan's gross national product reached 0.32 percent in 1980, but was still below the DAC average of 0.37 percent.

Regional disbursements also shifted during this period. In 1973, for example, 88 percent of ODA funds went to Asia, while only 2.6 percent was spent in Africa and 1 percent in the Middle East. By the end of the 1970s the rearrangement of funds was institutionalized in the so-called 7-1-1-1 formula: 70 percent of development aid to Asia, with the rest divided fairly equally among the countries of Africa, Latin America and the Middle East.

Continuing the drive to respond to world expectations, the second ODA doubling plan for fiscal years 1981-85 was initiated. Its implementation coincided with a slowdown in domestic economic growth -- a period of extreme fiscal austerity along with sporadic weakness in the yen's value beginning in 1982. Under these conditions, the ambitious goal to provide $21.4 billion in aggregate assistance fell behind schedule almost immediately, as spending levels dropped well below the $4.3 billion average required annually to meet the plan's target.

Transition

The reasons behind the shortfall are various. First, although ODA was exempt from the budgetary ceiling imposed on other spending items and its increase was larger than any other category's, requests submitted by the Foreign Ministry were pared down each year by the austerity-minded Finance Ministry. Second, a drop in the funding level for multilateral institutions linked to a 1982 decision by Washington to reduce or delay its contributions created a lag in Tokyo's capital flows that even a 103.6 percent increase in 1983 and a 41.6 percent increase in 1984 could not cover. And last, the depreciation of the yen eroded Tokyo's efforts. Calculated in yen, Japan's projected ODA spending will only narrowly miss the doubling target, but in dollars -- the standard reference currency for aid -- total outlays will amount to roughly 88 percent of the doubling goal.

Aid spending in 1984 increased 14.8 percent to a record $4.3 billion, but reaching the five-year target figure by the end of fiscal 1985 (March 31, 1986) would require an estimated $7.1 billion in assistance this fiscal year, a 64 percent increase over 1984 expenditures. After fierce bureaucratic infighting, the FY 1985 budget provided for an ODA increase of only 11.4 percent, and Foreign Ministry officials were forced to acknowledge officially that the second plan would not reach its declared target.

Still, the figures for 1984 are impressive, gathering kudos from both the OECD and Washington. Japan's contributions are second in dollar terms only to the United States', and account for 15 percent of total aid flows from DAC countries. The ratio of ODA to GNP increased to 0.35 percent, ranking Japan eleventh among the 17 DAC member-nations. Achievement of the DAC average ratio of 0.36 percent is now within reach, even though the United Nations' recommended 0.7 percent level remains a challenge to be met.

Japan's bilateral assistance increased slightly to a little over $2.4 billion in 1984, with an increase of almost 14 percent in technical assistance categories. Multilateral aid reached a record $1.9 billion, due mainly to large contributions to the World Bank's International Development Association. The ratio of multilateral ODA to total ODA increased from 35.5 percent in 1983 to 43.8 percent in 1984. Less-concessional financial flows, including direct investment financing and export credits, continued to plunge, reflecting Tokyo's commitment to provide more generous forms of assistance to developing nations.

Tokyo has maintained its emphasis on providing grant aid and debt-relief assistance chiefly via multilateral organizations. Grants as a percentage of total ODA continued to rise between 1983 and 1984; however, the grant element of Japan's ODA, that is, the terms of its loans, dropped from 79.5 percent to 74.2 percent, still short of the OECD goal of 86 percent.

Regional and sectoral distribution of aid has generally continued to follow the pattern of recent years. Asia continues to receive the major portion of funding, with about one-third of total ODA going to the economically buoyant members of the Association of Southeast Asian Nations. China remains the largest single recipient of assistance, receiving $389.4 million in 1984, with geopolitically important countries such as Egypt and Pakistan also among the top ten beneficiaries.

Public utilities are still a main focus of assistance efforts, accounting for 41 percent of total ODA. Agriculture and fisheries are next with 13 percent, and mining, industry and construction rank third at almost 10 percent. It is important to note, however, that significant increases in spending on social infrastructure and welfare begun in 1982 have continued, reflecting Tokyo's belief that the long-term solution to the international debt problem lies in basic improvements in economic and social welfare that will stimulate the productivity and economic strength of the developing nations.

The Seven-Year Doubling Plan

While the outcome of the FY 1986 budget is not final, the Foreign Ministry, as chief ODA spokesman, seems to have once again preserved an increase for aid, although the request for a 10.4 percent rise in spending lags behind FY 1985's 11.4 percent boost. The net increase in aid outlays, therefore, will fall from Y60 billion ($273 million at Y220=$1.00) this fiscal year to Y58 billion ($264 million) in 1986. Even so, if the double-digit increase survives, ODA will have the highest percentage increase of any item in the budget again this year.

Given the Finance Ministry's crimp on ODA expansion and the second doubling plan's narrow miss, a new aid initiative was essential. The new plan was announced in July by Foreign Minister Shintaro Abe, long a staunch political supporter of ODA, during the first round of the FY 1986 budget process, and was reportedly a major debating point in the early budget negotiations.

On September 18 the Japanese cabinet approved the third medium-term plan, calling for a doubling of ODA by the end of fiscal 1992. The seven-year program envisions aggregate spending at more than $40 billion, largely through increases in grant aid and technical cooperation, expanded commitments to international financial institutions, and improvements in the disbursal rate of yen loans. If the program proceeds as planned, ODA will rise to an estimated 0.42 percent of GNP in 1992.

Recognizing that number targets alone are insufficient to represent Japan's determination to fulfill its development responsibilities, qualitative improvement of ODA is the second major objective of the new plan. Effective and efficient implementation through strong project management, better coordination of technical and financial cooperation efforts, improved and expanded evaluation of programs, stronger private sector coordination, and increased cooperation with other donor nations and international organizations are some of the broadly defined means of reaching that goal. To assist the government, a private panel of advisers has been charged to make specific recommendations about improvements in Japan's aid program.

The third medium-term doubling plan and the show of considerable political will in the face of harsh bargaining during the annual budget process indicate that Tokyo's commitment to development assistance remains strong. This was clear when the major theme chosen for Foreign Minister Abe's October speech to the U.N. centered on Japan's aid programs and philosophy. But although aid is considered a foreign policy necessity, Tokyo's outlook continues to evolve as questions surrounding objectives and implementation are answered.

Problems and Prospects

With the tremendous surge in aid commitments since 1977, some observers have pointed out that the new development objectives are less ambitious than previous programs and represent a cooler, less committed approach. The seven-year stretch for the new doubling goal is cited by critics as an example. Nervousness about this perception prompted members of the ruling Liberal Democratic Party to initiate a review of the newly submitted plan in October of this year to determine if the target could be reached at an earlier date.

The seven-year doubling plan does not indicate a change in Tokyo's commitment to development assistance but rather reflects an aid policy reassessment process formally initiated by the government several years ago. Discussions over the management of the foreign policy centerpiece that aid has become have broadened to include not only government officials, but active participation by politicians, business leaders and the media. The open forum features candid assessments of existing problems as well as proposals for reform, many of which are addressed in the new plan.

A focal point of controversy within the aid community is the response to criticism that interest rates and repayment schedules on Japan's development loans are still too tough. But the wisdom of easing loan terms too much is questioned by many officials whose views are grounded in the idea that "economic cooperation" -- the term for assistance the government prefers -- should be a joint effort between donor and recipient nations. If there is no built-in obligation for recipient countries to make their development projects efficient or even commercially viable, the reasoning goes, development efforts will never enable poor nations to stand on their own economically.

This philosophical stance has slowed down moves by Prime Minister Yasuhiro Nakasone and other political and economic leaders to improve the quality of aid, that is, to expand the grant element of ODA and ease loan repayment terms. Meeting international standards of performance is very much the point of Japan's aid policy, after all. Thus the importance of doing well in the comparative standings compiled by the OECD, particularly in the "grant element" index, is a major concern.

American aid experts point out that Japan faces a severe image problem within the donor community -- stemming mostly from the perception that Tokyo's development assistance reflects a preoccupation with domestic economic gains. Recent incidents such as the aid/export credit package that won the lucrative Bosphorus Bridge contract for Japanese firms underline this perception. Leaving aside the tied-aid question, critics charge specifically that the manner in which new ODA projects are determined give Japanese business interests too much access.

This is basically a problem of a procedure that is too closely tied to doctrine. Japan's decisions on development projects are locked into a self-help philosophy that requires developing countries to ask for assistance before projects are initiated. This allows influential Japanese firms to lobby recipient governments about project requests. In fact, the crucial, conceptual stage of development planning is closed to government since development proposals cannot originate from any of the departments or agencies involved in foreign assistance. All feasibility studies and consultations occur after the initial request. Changing this aspect of ODA policy seems to be high on the Nakasone administration's list of reforms.

Once projects are identified they must make their way through a slow and inflexible approval and implementation process that is also the source of considerable criticism both in Japan and within the donor community. Aid programs have the benefit of little legislative interference, but the bureaucratic tangle is impediment enough. Official yen loans must be approved by four (usually feuding) institutions that often have conflicting viewpoints -- the Finance Ministry, the Foreign Ministry, the Ministry of International Trade and Industry, and the Economic Planning Agency.

The coordination of grants, loans and technical cooperation is extremely difficult since the two principal implementing organizations -- the Overseas Economic Cooperation Fund, which oversees loans, and the Japan International Cooperation Agency, with responsibility for grants and technical assistance -- divide aid duties and even have different supervisors, the Economic Planning Agency and the Foreign Ministry, respectively. The overlap in roles and missions spreads to other agencies as well. For example, the independent Export-Import Bank of Japan shares with the OECF the job of providing loans to corporations involved in development projects.

The expansion of the ODA program has further hobbled the bureaucracy. Almost one-third of the OECF budget each year remains unused and the backlog of general ODA disbursements is growing. The reasons behind this include the difficulty of identifying projects and getting them through the approval pipeline, overburdened personnel, a trend toward funding smaller projects and those with multi-year disbursements, and conservative loan policies.

ODA projects have also come under strong attack because of poor follow-up procedures, i.e. the lack of funds for technical experts, operating activities, infrastructure and maintenance. A case in point involves a bridge in Zaire that was inaccessible because no road was constructed to get to it. This may primarily be a result of inexperience in development planning. The Foreign Ministry is currently re-evaluating project development with an eye to increasing the overall effectiveness of its programs. Of particular concern is the expansion of technical personnel exchanges in line with Japan's intensified objective to increase technical cooperation with developing countries.

The concept of human resource development is in close keeping with the "heart-to-heart" relations between Japan and developing nations promoted under the Fukuda Doctrine. But its implementation has remained difficult for a number of reasons, including a shortage of qualified personnel, language barriers and the difficulty of re-entering Japanese society after a substantial absence.

Some progress has been made, however. Currently, the Japan Overseas Cooperation Volunteers, an organization similar to the U.S. Peace Corps, has twice as many volunteers as it had in 1982; a record 800 individuals were working for the organization overseas in 1985. Stepped-up technical training exchanges were announced by Foreign Minister Abe earlier this year. Moreover, the crisis in Africa has sparked new interest in what individual efforts can do internationally. Striking examples of this include a campaign led by Mr. Abe to collect blankets for Africans and a rash of privately sponsored fund drives. Donations by voluntary agencies to underdeveloped nations rose 37 percent over 1983 levels last year.

The Role of U.S.-Japan Relations

During a time of heightened tensions over the bilateral trade imbalance and defense spending, the United States and Japan have welcomed the refreshingly non-contentious collaboration on aid programs. Aside from improving political ties in the developing world, Washington views joint efforts with Tokyo as a means of extending its scarce financial resources to increase the net benefit of its development assistance. For Tokyo, joint cooperation brings the opportunity to express its commitment to become a responsible ally involved in the international community. Aid professionals also see it as a means for Japan to acquire U.S. aid expertise. Consultations and joint project planning between the two countries have increased considerably over the past several years.

The relationship is not without its sensitivities, however. Japan and the United States have development assistance objectives that, as analyst Susan Pharr of the Center for Strategic and International Studies has pointed out, both converge and diverge. One increasingly pressing issue for Tokyo's aid professionals has been the use of aid for political/strategic objectives, a primary component of U.S. assistance. In limited instances, aid has been used by Japan as an overtly political tool; freezing aid to Vietnam as a lever to open discussions with Hanoi and concerned parties over Cambodia, for example. Yet Tokyo remains uncomfortable with the concept; "strategic" aid is not even a part of the aid community's lexicon. This is largely a legacy of the foreign policy practices of three decades. While strongly tied to the United States, Tokyo had worked out a delicate vocabulary of diplomacy that enabled it to sidestep some of the questions raised by tense East-West relations.

When Prime Minister Nakasone took office in 1981, his overtly expressed desire to cooperate with U.S. foreign policy objectives and be a "member of the West" rearranged that carefully balanced stance. Along with the general regional realignment of funds, this translated into increased assistance for countries that lean toward the democratic system of government or that the United States has singled out to receive "persuasive" aid. An example of this rationale put into practice is assistance to China in order to buttress the relatively moderate Deng regime and maintain a funding alternative to the U.S.S.R. The 1983 policy turnaround on aid to South Korea can be considered strategically motivated as well. (See JEI Report No. 41A, October 25, 1985.)

The particular uses of aid have not been singled out for criticism, but Japan's new position has not gone unremarked. Opposition party forces and even some members of the ruling party question how funds such as those earmarked for Jamaica in support of the Reagan administration's Caribbean Basin Initiative relate to Japan's economic cooperation philosophy. Japanese officials, however, have reportedly assured their American counterparts that the trend toward politically astute assistance will continue.

Concurrently, another political use of aid is under consideration. To counteract the friction generated by trade disputes, some Japanese officials have suggested purchasing foreign products for re-distribution as aid to developing nations, a sort of Japanese 'Marshall Plan." This tactic has been tried before: to help settle a 1978 disagreement with New Zealand over fishing rights and agricultural trade, Tokyo bought surplus powdered skim milk for donation to poor countries.

Now high-level interest has been expressed about a plan to purchase surplus American grain for distribution as grant-aid. When first proposed this spring by Agriculture Under Secretary Daniel Amstutz as a way to help the depressed U.S. farm economy and expand the scope of Japan's food aid program, Japanese officials balked. However, in late September Prime Minister Nakasone told party officials to study the option and during his October visit to

Washington, LDP president Susumu Nikaido notified U.S. officials that the issue was under consideration. Reportedly being discussed are purchases of 10 million metric tons of grain over a period of four to five years, financed by a joint public-private fund.

Conclusion

Japan's development aid policy reflects a country that is wrestling with national priorities and world responsibilities. Support for worldwide development objectives, economic profit, secure markets, access to raw materials, influence in world forums and solidarity with allies are some of the issues invoked by aid. Because all these subjects touch on the image Japan is constructing for domestic and international consumption, they are bound to be caught up in public emotions. It is not surprising that development is a highly politicized subject and that it is linked to foreign policy, global trade and long-term economic planning. What perhaps is surprising is that there is domestic awareness and criticism of current aid policies and programs.

Japan's ODA policies are evolving in an atmosphere of self-examination that is intensified by pressures from the United States and the international community. In view of the complexities of the aid issue, it may be too much to ask of any country's officials to pioneer a new, more responsible approach to the problems of underdevelopment. But certainly, in recent years, Tokyo has proven that it is more than willing to join other nations and give it a try.

For further information, contact Sheri Hoptman.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Total Net Flow of Financial Resources from Japan to Developing Countries and Multilateral Agencies, 1983-84

(in millions of dollars)

Type of Transaction	1983	1984	Percent Change 1983/84
I. Official Development Assistance (ODA)	$3,761	$4,319	14.8%
Change Over Previous Year	24.4%	14.8%	
ODA/GNP Ratio	0.32%	0.35%	
A. Bilateral Assistance	2,425	2,427	0.1
1. Grants	993	1,064	7.1
Grant Assistance	535	543	1.5
Technical Assistance	458	521	13.6
2. Development Lending and Capital	1,432	1,363	-4.8
B. Grants, Capital Subscription and Loans to Multilateral Agencies	1,336	1,891	41.6
II. Other Official Flows (OOF)	1,954	743	-62.0
A. Export Credits (over 1 year)	472	493	4.4
B. Direct Investment Finance and Others	1.442	380	-73.6
C. Transactions with Multilateral Agencies at Market Terms	41	-130	
III. Private Flows	4,779	10,946	129.1
A. Direct Investments	433	1,489	244.1
B. Export Credits (over 1 year)	-2,069	-655	
C. Other Bilateral Securities and Claims	4,840	7,753	60.2
D. Multilateral Private Flows	1,574	2,360	49.9
IV. Grants by Voluntary Agencies	30	41	37.1
Total Official and Private Flows (I + II + III + IV)	10,523	16,049	52.5
As Percentage of GNP	0.92	1.30	
For Reference			
Export Credits (total)	-1,597	-162	
Direct Investments and Others (total)	1,874	1,869	0.3

Notes: 1. Net disbursement basis.
2. Due to rounding, the figures do not necessarily add up to the totals.

Source: Ministry of Foreign Affairs, August 30, 1985.

Table 2: Major Recipients of Japan's ODA, 1980-84

(in millions of dollars)

1980		1981		1982		1983		1984	
Country	Amount	Country	Amount	Country	Amount	Country	Amount	Country	Amount
Indonesia	$350	Indonesia	$300	China	$369	China	$350	China	$389
Bangladesh	215	South Korea	296	Indonesia	295	Thailand	248	Malaysia	245
Thailand	190	Thailand	214	Bangladesh	216	Indonesia	236	Thailand	232
Burma	152	Philippines	210	Thailand	170	Philippines	147	Indonesia	168
Egypt	123	Bangladesh	145	Philippines	137	India	130	Philippines	160
Pakistan	112	Burma	125	Burma	104	Burma	114	Bangladesh	123
Philippines	94	Pakistan	118	Pakistan	95	Bangladesh	104	Burma	95
South Korea	76	Egypt	71	Malaysia	75	Malaysia	92	Egypt	81
Malaysia	66	Malaysia	65	Sri Lanka	62	Sri Lanka	73	Pakistan	67
Sri Lanka	45	Turkey	51	Egypt	62	Pakistan	73	Sri Lanka	64

Note: Net disbursement basis.

Source: Ministry of Foreign Affairs

Table 3: Japan's Official Development Assistance by Region, 1983-84

(in millions of dollars)

Year	Total	Asia	Middle East	Africa	Latin America	Europe	Oceania	Unallocable
1983	$2,425 (100.0%)	$1,614 (66.5%)	$150 (6.2%)	$287 (11.8%)	$241 (9.9%)	$23 (1.0%)	$18 (0.7%)	$93 (3.8%)
1984	$2,427 (100.0%)	$1,594 (65.7%)	$184 (7.6%)	$240 (9.9%)	$229 (9.4%)	$38 (1.6%)	$25 (1.0%)	$117 (4.8%)

Note: Net disbursement basis.

Source: Ministry of Foreign Affairs

Table 4: Sectoral Distribution of Bilateral ODA Commitments, 1983-84

(in millions of dollars)

	1983	1984	Percent Change 1983/84	Distribution 1983	Distribution 1984
Public Utilities (incl. transportation and communications)	$1,653	$1,605	-2.9%	47.5%	40.5%
Mining, Industry and Construction	415	389	-6.3	11.9	9.8
Agriculture and Fisheries	360	498	38.3	10.3	12.5
Education	216	188	-13.0	6.2	4.7
Food and Disaster Relief	149	121	-18.8	4.3	3.0
Social Infrastructure and Welfare	130	170	30.8	3.7	4.3
Health	129	136	5.4	3.7	3.5
Unspecified	432	858	98.6	12.4	21.6
Total	3,484	3,965	13.8	100.0	100.0

Note: Commitment basis.

Source: Ministry of Foreign Affairs

Table 5: Official Development Assistance of Major Donor Countries, 1984

(in millions of dollars)

Rank	Country	Amount	Percent of Total DAC ODA 1983	Percent of Total DAC ODA 1984
1	United States	$8,698	28.9%	30.4%
2	Japan	4,319	13.7	15.1
3	France*	3,790	14.2	13.3
4	Germany	2,782	11.6	9.7
5	Canada	1,625	5.2	5.7
6	United Kingdom	1,432	5.8	5.0
	Other Donors	6,001	20.6	20.9
DAC Total		28,647	100.0	100.0

*Includes overseas territories and prefectures.

Source: Organization for Economic Cooperation and Development

Table 6: Official Development Assistance of DAC Countries, 1983-84

(in millions of dollars)

Rank*	Country	1983 Amount	1983 Percent of GNP	1984 Amount	1984 Percent of GNP	Percent Change 1983/84
1	Netherlands	$1,195	0.91%	$1,268	1.02%	6.1%
2	Norway	584	1.09	526	0.99	-9.9
3	Denmark	395	0.73	449	0.85	13.7
4	Sweden	754	0.84	741	0.80	-1.7
5	France**	3,815	0.74	3,790	0.77	0.7
6	Belgium	487	0.60	434	0.56	-10.9
7	Canada	1,429	0.45	1.625	0.50	13.7
8	Australia	753	0.49	773	0.45	2.6
9	Germany	3,176	0.48	2,782	0.45	12.4
10	Finland	153	0.32	178	0.36	16.3
11	Japan	3,761	0.32	4,319	0.35	14.8
12	United Kingdom	1,610	0.35	1,432	0.33	-11.1
13	Italy	833	0.24	1,105	0.32	30.1
14	Switzerland	320	0.31	286	0.30	-10.6
15	Austria	158	0.23	181	0.28	15.0
16	New Zealand	61	0.28	59	0.27	-3.3
17	United States	8,055	0.24	8.698	0.24	8.0
DAC Total		$27,540	0.36	$28,647	0.36	4.0

*Countries are ranked by ODA as percentage of donor GNP in 1984.
**Including overseas territories and prefectures.

Source: Organization for Economic Cooperation and Development

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Japanese Panel Starts Work On Reform Of Economy

Prime Minister Yasuhiro Nakasone has established an advisory committee to report on policies Japan should pursue to harmonize its economic relations with other countries. The 17-member panel, which is chaired by former Bank of Japan governor Haruo Maekawa, consists of academic, business and government leaders, including Yoshio Okawara, former ambassador to the United States. The committee is expected to work out specific policy proposals by next March.

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the dispute. More than a year ago, the administration said it supported the "water's edge" approach, which allows states to tax a percentage of a firm's domestic income. It threatened pre-emptive legislation if the states were unable or unwilling to adopt this approach. Of the six states that retain the worldwide unitary tax (the other five are Montana, Idaho, North Dakota, Alaska and New Hampshire), California is by far the most important. A resolution of the issue in California would have a significant impact on the drive to curtail its utilization.

Reactions to the latest development were predictable: unitary tax supporters, outraged by the action, decried the assumption of state prerogatives by the executive, while anti-unitary tax forces applauded the move. Officially, the Japanese government is assuming a wait-and-see posture, but the action certainly must satisfy Japanese private-sector groups, many of whom intimated earlier in the year that their hopes for administration-sponsored legislation had not been abandoned despite the shift in lobbying emphasis. Final details, however, are still as scarce as they were four weeks ago, when rumors of administration actions were first floated.

Michael W. Chinworth

Bilateral Trade Deficit Headed For $50 Billion Mark This Year

A favorite pastime in the economics profession not long ago was knocking the Reagan administration for missing the mark in most of its economic projections. About the only number the government seemed to have a handle on, noted private forecasters, was the trade imbalance. At the start of the year, Washington pegged 1985's overall trade deficit at $150 billion (imports valued c.i.f.), up from last year's once-unimaginable $123 billion red-ink entry. With the deficit already at $107.6 billion through September, this estimate should be right on target. Imports, although only 4 percent higher at $268.4 billion than the January-September 1984 tally, still have the biggest buying season on tap, while exports show no signs of overcoming the sluggishness that trimmed them 0.7 percent during 1985's first three quarters to $160.8 billion.

The U.S. trade deficit with Japan, which reached $36.8 billion in 1984, should also come in close to the administration's $50 billion projection (imports again valued c.i.f.). At $36.9 billion as of September, the bilateral imbalance was three-fourths of the way toward this mark. Moreover, a fourth quarter red-ink total of $13 billion or so is certainly not out of the question given the fact that the deficit was in this neighborhood in both the April-June period ($13.1 billion) and the July-September quarter ($12.7 billion). (With imports valued on a Customs basis, the 1985 U.S. trade deficit with Japan is headed for the $46 billion range, after hitting $34.2 billion in the year's first nine months and $33.6 billion in full-year 1984.)

The political fallout generated by the expanding bilateral trade imbalance has become a fact of life for Japanese policymakers over the past two years. In 1984 Tokyo could at least counter that the fast-rising U.S. deficit with Japan played just one part in this country's mounting trade problems, contributing only one-fourth-plus of the deterioration in the aggregate trade account. In 1985, however, Japan's trade negotiators do not have even this

U.S. Exports to Japan

(in millions of dollars, f.a.s. value basis)

	January-September 1984	January-September 1985	Percent Change
Total Exports	$17,416.8	$17,063.8	-3.7%
Industrial Supplies	6,718.7	6,468.2	-3.7
Bituminous Coal	699.0	608.4	-13.0
Petroleum Products	496.8	544.1	9.5
Natural Gas	196.9	185.8	-5.6
Nuclear Fuels	129.1	88.2	-31.7
Logs and Lumber	651.1	651.6	0.1
Paper Base Stocks	401.3	360.1	-10.3
Paper and Paper Products	222.6	210.3	-5.5
Organic Chemicals	534.3	526.1	-1.5
Inorganic Chemicals	620.3	633.4	2.1
Plastics and Synthetic Resin Compounds	267.9	234.1	-12.6
Fertilizers and Insecticides	210.8	205.6	-2.5
Steel Scrap	198.0	142.7	-27.9
Nonferrous Ores and Scrap	257.1	368.5	43.3
Nonferrous Metals	299.1	239.5	-19.9
Textiles	86.3	83.1	-3.7
Raw Cotton	453.2	309.2	-31.8
Hides and Skins	243.0	216.6	-10.9
Leaf Tobacco	42.9	83.4	94.4
Capital Goods	4,064.1	4,490.1	10.5
Nonelectric Machinery	2,520.5	2,624.9	4.1
Data Processing Equipment	825.8	1,045.1	26.6
Measuring, Testing and Control Instruments	325.6	348.2	6.9
Laboratory Testing and Control Instruments	70.1	80.2	14.4
Scientific, Professional and Medical Equipment	186.0	200.7	7.9
Power Generating Equipment (excl. aircraft and automotive engines)	230.9	55.7	-75.9
Metalworking Equipment	77.2	83.6	8.3
Service Industry Equipment	84.8	92.9	9.6
Electric Machinery	656.3	614.5	-6.4
Generators and Transformers	70.0	54.3	-22.4
Broadcast and Communications Equipment	324.3	251.0	-22.6
Telephonic and Other Electric Equipment	262.0	309.2	18.0
Transportation Equipment	887.3	1,250.6	40.9
Civilian Aircraft	304.9	632.5	107.5
Civilian Aircraft Engines and Parts	341.5	406.4	19.0
Automotive Parts	132.8	156.0	17.5
Food and Feed	4,577.8	3,772.7	-17.6
Corn	1,553.6	953.3	-38.6
Sorghum	163.4	152.0	-7.0
Soybeans	899.2	663.3	-26.2
Wheat	402.0	365.6	-9.1

Fruits and Vegetables	349.3	350.3	0.3
Meat and Meat Products	430.4	391.6	-9.0
Fish and Fish Products	450.0	618.8	37.5
Consumer Goods	1,114.8	1,093.4	-1.9
Pharmaceuticals	424.4	461.7	8.8
Toys and Sporting Goods	69.1	62.8	-9.1
Cigarettes	74.6	69.5	-6.8

U.S. Imports from Japan

(in millions of dollars, Customs value basis)

	January-September 1984	January-September 1985	Percent Change
Total Imports	$43,321.8	$51,281.8	18.4%
Automotive Products	14,114.6	18,197.4	28.9
Cars	9,465.6	11,705.8	23.7
Assembled Trucks	2,176.7	3,107.7	42.8
Automotive Parts	2,424.2	2,913.0	20.2
Capital Goods	14,577.1	16,313.9	11.9
Nonelectric Machinery	9,782.0	11,013.3	12.6
Business Machines	4,874.5	4,777.5	-2.0
Metalworking Machinery	691.3	943.4	36.5
Agricultural Machinery	273.8	281.6	2.9
Specialized Industrial Machinery	1,095.2	1,002.4	-8.5
Scientific, Professional and Medical Equipment	353.3	490.7	38.9
Electric Machinery	4,529.6	4,886.7	7.9
Transportation Equipment	265.6	413.9	55.8
Consumer Goods	8,466.1	10,363.8	22.4
Video and Audio Recorders and Players and Stereo Equipment	2,792.0	3,968.6	42.1
Television Sets	523.4	596.2	13.9
Radio Receivers	226.7	236.1	4.2
Tableware and Glassware	311.4	326.2	4.8
Metal Cookware and Cutlery	299.4	315.7	5.4
Photographic and Optical Goods	775.6	657.2	-15.3
Clocks and Watches	317.5	363.8	14.6
Toys and Sporting Goods	299.7	411.3	37.2
Motorcycles and Parts	520.2	600.1	15.4
Clothing	385.7	382.5	-0.8
Intermediate Goods	5,542.5	5,504.1	-0.7
Steel Mill Products	2,353.7	2,463.0	4.6
Nonferrous Metals	397.1	400.7	0.9
Organic Chemicals	401.4	441.3	9.9
Tires and Tubes	392.8	431.8	9.9
Textiles	522.0	533.3	2.2

out: fully three-fourths of the jump in the overall U.S. trade deficit is attributable to the increased flood of red ink with Japan.

This attention to the bottom line, while understandable, ignores a number of positive developments in U.S.-Japan trade. Although total exports are off because of falling sales of industrial and agricultural inputs, high technology products are doing well almost across the board (see accompanying tables). Jet transports are only the biggest winners on a list that includes computers and peripheral equipment, measuring and testing instruments, scientific and professional equipment, and pharmaceuticals.

Of note as well is the slower growth posted by all the end-use import categories. Capital goods, last year's high fliers, are rising at a fairly moderate rate in 1985, mainly because of cut-back purchases of business machines. Even purchases of automotive products are increasing at a reduced rate despite the higher ceiling on Japan's U.S.-bound car shipments.

Susan MacKnight

Notes

- International Business Machines Corp. and the Ministry of International Trade and Industry signed an accord November 5 that could have a strong impact on the global information industry. The Armonk, New York-based computer giant gained immediate access to over 700 electronics-related Japanese patents controlled by MITI. Until now, foreign firms were barred from licensing publicly held patents that were the result of government-sponsored research projects (see JEI Report No. 32B, August 23, 1985). Competing American and Japanese computer makers are worried that the accord will strengthen IBM's already daunting competitive position. A rush of foreign firms seeking similar deals is expected in the near future.

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REPORT

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U.S.-JAPAN COMPETITION IN PHARMACEUTICALS

Summary

Japan's high-flying pharmaceutical industry has had its wings clipped. No longer can drug makers count on double-digit sales gains at home to fund the research that transformed them during the 1970s from manufacturers and distributors of licensed products into developers of safer, more effective versions of existing drugs and, more recently, originators of some innovative compounds. Tokyo's campaign to contain its soaring health-care bill has meant flat or even lower sales and earnings for the leading Japanese drug producers. And in a double blow, domestic heavyweights from other business fields continue to diversify into pharmaceuticals, while big American and European drug companies are starting to flex their competitive muscles in the Japanese marketplace. To help recoup development costs, Japan's drug manufacturers are licensing their products to foreign firms; a few are also setting up marketing joint ventures with pharmaceutical houses in the United States and Europe. The returns from this strategy have so far been meager, raising questions about the future competitive status of the Japanese industry.

Playing Catch-up

International competitiveness in the modern pharmaceutical industry hinges on the ability of companies to develop and bring to market a small but steady stream of commercially successful new ethical drugs -- patented products promoted to health professionals and available to consumers by prescription only. Underlying this capacity is a substantial commitment to research and development, both in terms of money and time. Current estimates peg the cost of discovering, developing and introducing an innovative drug in the United States at $80 million-plus, while industry sources in Japan place the cost there of moving versions of existing products out of the laboratory at $20 million and up. Costs, already high because only one out of nine or ten potential new drugs is successfully marketed, have been inflated in both countries by the more extensive toxicology testing and clinical (human) trials now required for regulatory approval of a new compound. Moreover, the process of bringing a new drug to market can take up to 10 years in the United States and even longer in Japan.

By this standard, Japanese pharmaceutical companies are only now beginning to emerge as world-class competitors, having spent the last two decades gaining the financial capability and technical expertise to develop drugs on their own. Japanese firms have largely weaned themselves from almost complete dependence on products licensed from American and European makers, although Tokyo did play a major role in this process during the 1960s and 1970s by fostering a market and business environment conducive to innovation. The creation of a national health-insurance system in 1961 and the decision to allow doctors to dispense drugs bought at prices negotiated with manufacturers, for example, ensured that demand for prescription pharmaceuticals, whether patented or generic (off-patent compounds), would expand at a fast pace. In addition, the government's drug reimbursement system was structured to favor new products at the expense of established brands, giving drug makers an additional inducement to invest in research and development.

Changes in the legal protection afforded new pharmaceutical products also spurred innovation. Prior to January 1976, patents in Japan were granted only on new processes, never on substances. This situation discouraged R&D since companies could legally produce imitations of drugs marketed by other firms simply by coming up with a different production process. Allowing pharmaceutical houses to patent the active ingredient in a new compound for 15 years eliminated this disincentive, but it highlighted another -- the fact that most of the life of a patent has passed before a new drug appears on the market. Tokyo's solution to this problem, effective April 1980, was to extend the period of exclusive sales rights for a new product from three years after it receives production approval to six.

Industry executives and government officials in the United States also maintain that Tokyo encouraged domestic drug development by restricting the activities of American and European companies in Japan. They argue that the ban on the formation of wholly owned foreign manufacturing subsidiaries from 1964 until mid-1975 and regulations that made it hard for firms overseas to supply the Japanese market through exports, including the rule that a new drug could not be registered in Japan unless most preclinical work and all clinical testing was done there, left foreign companies little choice but to license their products to Japanese businesses. Production and/or distribution of licensed products, these critics add, quickly became a major funding vehicle for the domestic R&D effort.

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Against this backdrop of largely indirect government support, a dozen specialized prescription drug makers rose to the top of Japan's pharmaceutical industry. Led by Takeda Chemical Industries, Ltd., Sankyo Co., Ltd. and Fujisawa Pharmaceutical Co., Ltd., these companies undertake a significant amount of basic and applied research and development, investing a minimum of 5 percent of total sales in this work. More importantly, each of them has demonstrated the ability to come up with at least a handful of commercially successful new products.

Forming the industry's second tier are another 12 or so specialized producers. Not only do they have lower revenues than their bigger rivals, but their research and development capacity is generally much weaker, in large part because of the limited availability of funding. Below this group are some 300 small and medium-sized companies. Primarily manufacturers of generic drugs with little or no R&D targeted at new drug discoveries, these firms are being squeezed by government policies designed to bolster more innovative companies through greater patent and pricing protection.

Despite the widely divergent abilities of Japanese pharmaceutical companies to undertake new drug development, industry R&D expenditures climbed from Y55 billion ($200.9 million) in FY 1973 to Y289.9 billion ($1.2 billion) in FY 1983. The payback from this effort can be seen in the jump in new drug introductions by Japanese companies. After unveiling a total of just 155 products in the 20 years through 1980 -- far short of the comparable tallies for the United States (353), France (271) and West Germany (201), Japanese firms moved to the top of the list in the 1981-83 period, bringing to market 41 compounds versus 24 for American corporations, 16 for German businesses and 13 for French competitors.

Antibiotics represent the leading edge of the new drugs coming out of Japanese laboratories. Almost to a company, the top drug firms targeted this class of products for their initial R&D efforts, attracted by the big profits that can be earned from discovering and commercializing replacements for antibiotics no longer effective against certain types of bacteria. Largely bypassing penicillin-type antibiotics, Japanese researchers zeroed in on cephalosporins, which are structurally similar to penicillins but effective against a wider spectrum of bacteria. With a few exceptions, they missed out on the first two generations of cephalosporin products. By the time the third-generation versions appeared on the market in the early 1980s, however, most carried Japanese trademarks. Among the best sellers are Shiomarin, produced by Shionogi & Co., Ltd., the largest Japanese maker of antibiotics; Epocelin, a product of the number-two antibiotic manufacturer, Fujisawa; and Takeda's Bestcall.

Like their cephalosporin antibiotics, most of the other products introduced by Japanese pharmaceutical companies in recent years have been drugs exhibiting greater efficacy and/or safety than compounds already on the market. This fact does not detract from Japan's drug development work: incremental improvements in existing drugs, not breakthroughs, are the rule in the American and European pharmaceutical industries as well. Moreover, Japanese firms have a number of drugs in production or undergoing clinical trials that qualify as innovations in the treatment of cancer and cardiovascular problems.

A New Ball Game

With a big helping hand from the national health-insurance system and the government's generous reimbursement policies for new drugs, whether domestic or foreign, pharmaceutical makers became the high fliers of Japanese industry in the 1970s. Annual sales gains in the double digits were the norm; so were profit margins in the 12 to 13 percent range, even though drug companies were steadily increasing their outlays for R&D. The start of the 1980s, however, marked the arrival of a new era of business conditions for pharmaceutical firms.

Deciding that containment of the steep yearly rise in the government's bill for medical care took priority over the maintenance of a supportive market climate for drug companies, Tokyo initiated a major overhaul of its drug pricing policies. These policies were obvious candidates for reform. In contrast to the United States and Europe, where drug costs average an estimated 13 percent of total medical expenses, pharmaceutical products in Japan represent more than one-third of aggregate health-care expenditures. Moreover, repeated hikes in drug prices were one reason spending on medical care had topped 6 percent of national income by FY 1978.

The thrust of the drug-pricing reform program is straightforward: to narrow the gap between the government-set rates at which medical institutions and doctors are reimbursed for the drugs they use or dispense (standard or official drug prices) and the wholesale prices pharmaceutical companies charge for their products, which were roughly 10 to 20 percent lower for most drugs at the beginning of the 1980s but up to 40 percent less for some products. The mechanics of the revision are more complex.

At the risk of oversimplification, the government's initial step, implemented in February 1978, was to set standard prices for every brand of prescription medicine on the market, not just for groups of similar products, and to implement price cuts on a brand-by-brand basis. It then revamped the formula used to change official prices, going to a variant in January 1983 that more accurately reflects movements in actual selling prices. Moreover, in response to a September 1982 advisory commission recommendation, Tokyo decided to revise standard drug prices across the board at least once every three years, with partial reviews undertaken each year.

These changes do not appear very radical on paper; in practice they have been. In less than four years, average standard drug prices were pared by a cumulative 35 percent, with cuts of 18.6 percent in June 1981, 4.9 percent in January 1983, 16.6 percent in March 1984 and 6 percent this past March. Together with other cost-containment measures, these reductions sliced the annual growth in national medical expenditures from 12.6 percent in the FY 1977-FY 1979 period to 7.3 percent in the early 1980s and just 2.9 percent in FY 1984. But they also took the wind out of the pharmaceutical industry's sails, trimming the yearly increase in output to a single-digit figure and producing an industry first in 1984 -- a drop in production.

With medical institutions and doctors forcing pharmaceutical makers to absorb a major part of the cuts through lower wholesale prices, the effects of the government's pricing reforms quickly showed up on drug company books. By design, manufacturers of generic products have been hit the hardest, but second-tier producers are also starting to reel if they have no recently introduced big sellers from their own research labs on the market. Even the industry's leaders are feeling the pinch. Takeda's pharmaceutical sales have been flat for the last three fiscal years and its total operating income, derived mainly from drugs, has dropped by one-sixth. The story is no different at Fujisawa and Shionogi. Number-two Sankyo as well as Eisai Co., Ltd., Yamanouchi Pharmaceutical Co., Ltd. and Tanabe Seiyaku Co., Ltd. have managed to generate some growth in revenues, but their operating results are also on the decline.

Since Tokyo's cost containment drive shows no signs of flagging, Japanese drug companies are being forced to rethink corporate strategy. The obvious answer is to insulate themselves from the brunt of future price cuts by introducing products that can command high standard drug prices. This solution, however, is easier outlined than implemented. Aside from the time it takes to bring a new drug to market and the generally limited number of products companies now have in the pipeline, there is the money question.

Awed by the recent successes of Japanese companies in the international drug introduction sweepstakes, industry watchers often forget that Japanese pharmaceutical makers are midgets in a world industry dominated by American and European multinationals. With pharmaceutical sales of $1.2 billion in FY 1984, Takeda just makes the list of the world's 20 largest drug companies, while Sankyo's FY 1984 revenues of $0.8 billion would only rank it in the mid teens on a roster of the biggest U.S. drug manufacturers.

Japanese makers similarly fall short of their American rivals in R&D expenditures. The U.S. drug industry typically outspends its Japanese counterpart by a margin of almost three to one, allocating roughly 10 to 11 percent of sales to R&D compared with a 5 to 6 percent ratio in Japan. To cite just one example, Merck & Co., Inc., the top U.S. pharmaceutical company, earmarked 11 percent of its total 1984 revenues, or $393.1 million, for research and development, mainly in the drug field; in contrast, Takeda's total FY 1984 R&D expenditures of $117.9 million only equaled 6.1 percent of aggregate sales.

Competitors Flex Their Muscles

Already the big spenders in an industry where R&D funding levels are the key to competitive strength, American and European multinationals are not making it any easier for Japanese challengers to generate money at home for drug development. Over the last two years or so, major international players have launched phase one of a long-term campaign to beef up their position in the Japanese market. Companies previously content to just license their products to Japanese producers are establishing a production base in Japan. Foreign firms that had been manufacturing through joint ventures are buying out their Japanese partners or at least gaining a controlling interest in the operation. Many of these same companies are also switching marketing channels, replacing Japanese distributors with in-house sales forces. Moreover, one multinational after another has unveiled plans for an expanded research and development capability in Japan.

American and European drug makers are being pushed and pulled into a bigger presence in Japan. With drug development costs skyrocketing, they cannot afford a business-as-usual approach to the world's second-largest pharmaceutical market. At the same time, Tokyo has loosened -- but not removed -- the handcuffs on foreign drug firms. Since October 1976, for example, most preclinical work performed abroad has been accepted on new drug approval applications, while over the past two-and-a-half years the government has approved the use of American, Swiss and British data from acute and subacute toxicity tests, the major exception to the 1976 regulations. Under continued pressure from Washington, Japan has also backed away from its ban on foreign clinical test findings. As part of the July 1985 market access package, Tokyo agreed to accept the results of drug trials on foreigners for those tests unaffected by racial differences. This change will not eliminate the need for duplicative testing by U.S. and European drug companies anxious to introduce new products to the Japanese market, but it should reduce the cost and time involved in repeat testing.

Examples abound of the new aggressiveness of big international drug manufacturers in Japan, but the company that has captured the headlines is Merck. The top U.S. maker is a veteran of the Japanese market, having formed a joint venture with Banyu Pharmaceutical Co., Ltd. in 1954 to manufacture and market Merck products. By 1982 Nippon Merck-Banyu Co., Ltd.'s sales had reached $140 million or so, derived mainly from antibiotics, cardiovascular products and anti-inflammatories. This total placed Merck among the bigger foreign producers in Japan, but it fell far short of the amount of business the company thought it should be doing in the number-two drug market. The main problem, corporate executives concluded, was that the joint venture did not have a sales force large enough to go head-to-head with the top Japanese producers.

Merck's solution to its lack of marketing clout was unconventional. In back-to-back moves, it spent $300 million-plus to acquire a 50.02 percent stake in Banyu, a top-ten manufacturer, in a two-step transaction completed in October 1984, and bought a controlling interest in Torii Yakuhin K.K., a small drug company. With the merger of the Banyu and Nippon Merck-Banyu sales forces in January 1985, the American maker gained access to a sales force of more than 1,000 -- a number that puts it in the same league as Takeda and other big Japanese manufacturers. Moreover, Merck's five manufacturing sites and three research facilities in Japan place it on an equal footing with the country's major producers.

Merck's purchase of Torii and Banyu, which had sales of $250.6 million in FY 1984, has lifted the company to the head of the list of foreign drug producers, replacing Pfizer Inc. Like its larger rival, Pfizer is an old-timer in Japan, going back to 1953. But aside from switching partners in 1955 and gradually buying out that company's holding in Pfizer Taito Co., Ltd., Pfizer's rise to the top was strictly by the book. Pfizer Taito has built its sales force into an 880-person unit. The number-three U.S. drug manufacturer has also invested heavily in R&D in Japan, making Pfizer Taito's recently expanded Nagoya complex one of five major Pfizer research facilities around the world. In 1984, this two-pronged strategy and a product line slanted toward antibiotics produced sales of roughly $267 million for Pfizer in its top international market.

Despite their different Japan strategies, Merck and Pfizer have settled on the same marketing tactic -- direct distribution. West Germany's Hoechst A.G., number three in Japan but first in the world market, and Bristol-Myers Co. have also gone this route from the start of their Japanese operations. Foreign drug companies that took the opposite approach -- sales through distributors -- are now changing course, deciding that Japanese competitors are not the best candidates to handle their product lines. Schering-Plough Corp. took over distribution of its products in 1983 through its Essex Nippon K.K. unit, while Switzerland's Ciba-Geigy A.G., which had used the Takeda and Fujisawa sales networks for almost 30 years, put together a 600-person sales force this year. Other foreign manufacturers are likely to follow their example.

American and European competitors are also taking a page from Merck and Pfizer and expanding their Japanese research and development capacity. To cite just one example, the Upjohn Co., which already has a lab in Japan, announced earlier this year that it would invest $50 million in a new R&D facility; on completion, the complex will be the company's largest outside corporate headquarters. Other foreign drug companies, such as G.D. Searle & Co., are putting their money into a Japanese manufacturing presence.

Whatever the direction of their drive in Japan, multinational drug companies share a common objective: to raise their direct market stake from the estimated 15 percent level. A major push by the international industry's giants would be troublesome for Japanese challengers under any conditions, but it is doubly so when domestic demand for pharmaceutical products is marking time. To make matters worse, growing numbers of big Japanese companies from outside the industry are maneuvering to break into the drug business or have already diversified into pharmaceuticals.

New Game Plan Needed

Squeezed at home by both market and business forces, Japan's leading drug companies have moved into new territory -- the international market -- in an effort to expand funding for new drug development and recoup some of the costs of existing products. Licensing arrangements have been the main vehicle, with cephalosporin antibiotics and other innovative drugs providing the ticket. The list of companies that have licensed Japanese products reads like a who's who of the American and European pharmaceutical industries -- confirmation of Japan's prowess in new drug development but evidence as well that huge R&D costs are forcing major multinationals to cut back on in-house work.

Despite their numerous licensing agreements, Japanese drug makers are discovering what American manufacturers found out before them: that licensing arrangements are generally less profitable than direct sales. A glance at the trade data underscores this point. In FY 1983 Japanese drug companies received $42.1 million in royalties; in calendar 1983 Japan's exports of pharmaceuticals totaled $531.3 million, even though makers have been far less successful in international marketing than in licensing. Moreover, drug firms in Japan had to pay more in licensing fees in FY 1983 -- $52.3 million -- than they earned.

The money to be made from direct sales has persuaded a few major Japanese drug manufacturers to try selling in the American or European markets, but in venturing abroad, these companies have almost always tied up with foreign partners. Two such operations have been set up in the United States. In late 1981, Fujisawa and SmithKline Beckman Corp., which have had a joint marketing organization in Japan since 1977, formed a company in Philadelphia to develop and sell Fujisawa products. Their first drug, a third-generation cephalosporin, has been on the market for two years. The other joint venture pairs Takeda and Abbott Laboratories. TAP Pharmaceuticals was established in Chicago in 1977 to develop and market drugs based on Takeda's research. Its first product, introduced in May and manufactured by Abbott, is a treatment for advanced prostate cancer. Three other TAP products -- two cephalosporins and a benzodiazepine hypnotic sedative -- are awaiting Food and Drug Administration approval.

Operations such as these are still too few in number and new to have much impact on export earnings, either at the company or the industry level. In fact, overseas drug sales are equivalent to just 3 percent of Japanese production, and for some major producers like Sankyo and Shionogi, the ratio is not even that high. Moreover, increasing exports are doing nothing to narrow Japan's large deficit in pharmaceuticals, which has fluctuated between $800 million and $900 million in recent years.

The list of constraints on the money-making ability of Japanese drug manufacturers grows ever longer. Analysts in Japan have predicted for some time that the industry is headed for a shake-out that will eliminate many small and medium-sized producers. Such a development would take some pressure off of larger drug makers, but it would not guarantee the maintenance of their recently achieved international competitiveness. Business tie-ups or even mergers might still be necessary.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

Table 1: Japan's Pharmaceutical Market, 1980-84

	1980	1981	1982	1983	1984
	(in billions of yen)				
Production	Y3,482.2	Y3,679.1	Y3,980.2	Y4,032.1	Y3,966.9
Total Exports (f.o.b.)	93.9	101.7	108.0	126.2	128.8
Total Imports (c.i.f.)	262.4	275.7	332.4	311.5	321.1
Trade Balance	-168.5	-174.0	-224.4	-185.3	-192.3
Exports to United States (f.o.b.)	23.2	30.1	31.9	43.3	n.a.
Imports from United States (c.i.f.)	71.2	86.2	120.3	117.5	n.a.
Trade Balance	-48.0	-56.1	-88.4	-74.2	n.a.
Total Exports as Percent of Production	2.7%	2.8%	2.7%	3.1%	3.2%
Total Imports as Percent of Apparent Domestic Consumption	7.2%	7.2%	7.9%	7.4%	7.7%
Exports to United States as Percent of Production	0.7%	0.8%	0.8%	1.1%	n.a.
Imports from United States as Percent of Apparent Domestic Consumption	2.0%	2.2%	2.9%	2.8%	n.a.
	(in million of dollars*)				
Production	$15,357.7	$16,682.2	$15,979.6	$16,976.6	$16,701.3
Total Exports (f.o.b.)	412.4	462.5	434.9	531.3	543.6
Total Imports (c.i.f.)	1,151.5	1,253.5	1,338.8	1,311.2	1,355.3
Trade Balance	-739.1	-791.0	-903.9	-779.9	-811.7
Exports to United States (f.o.b.)	101.9	136.7	128.4	182.3	n.a.
Imports from United States (c.i.f.)	312.7	391.7	484.4	494.5	n.a.
Trade Balance	-210.8	-255.0	-356.0	-312.2	n.a.

*The following average annual exchange rates were used to convert the yen figures in dollars:
Production - 1980, Y226.74; 1981, Y220.54; 1982, Y249.08; 1983, Y237.52; and 1984, Y237.52.
Exports - 1980, Y227.67; 1981, Y219.90; 1982, Y248.33; 1983, Y237.52; and 1984, Y236.95.
Imports - 1980, Y227.85; 1981, Y219.94; 1982, Y248.30; 1983, Y237.55; and 1984, Y236.91.

Sources: Ministry of Health and Welfare and Japan Tariff Association

Table 2: Production of Pharmaceuticals in Japan, 1980-84

(in billions of yen)

	1980	1981	1982	1983	1984*
Antibiotics and Other Anti-infectives	¥814.3	¥780.1	¥865.2	¥735.9	
Cardiovascular Agents	377.8	438.0	440.3	509.2	
Central Nervous System Agents	344.2	353.9	387.6	395.5	
Miscellaneous Metabolic Agents	364.0	369.3	370.1	363.2	
Gastrointestinal Agents	256.8	282.6	321.5	340.6	
Vitamins	216.3	240.9	271.0	277.4	
Dermatological Agents	198.0	214.5	224.5	243.7	
Biologicals	114.4	140.1	157.5	163.9	
Antitumor Agents	107.4	122.6	124.5	134.7	
Nutrients, Tonics and Alternatives	85.7	97.7	113.6	119.1	
Medicines for the Blood	82.7	91.1	101.1	117.8	
Respiratory System Agents	80.0	86.1	90.6	98.7	
Hormones	89.3	85.1	97.3	95.7	
Peripheral Nervous System Agents	80.3	83.3	80.8	79.8	
Sensory Organ Agents	45.0	46.7	54.7	58.9	
Herb Medicines	33.8	47.6	58.3	53.7	
Drugs for Allergies	36.0	36.1	44.4	48.4	
Genitourinary Agents	34.6	35.7	41.5	40.9	
Diagnostic Agents	30.2	31.4	32.9	35.1	
Chemotherapy Drugs	29.5	28.6	30.2	33.6	
Other Pharmaceuticals	61.9	67.7	72.6	86.3	
Total Production	3,482.2	3,679.1	3,980.2	4,032.1	3,966.9

*The Ministry of Health and Welfare is in the process of revising the product categories that make up the pharmaceuticals production data. Product breakdowns for 1984 will therefore not be available until later this year.

Source: Ministry of Health and Welfare, Pharmaceutical Affairs Bureau

Table 3: Production of Prescription Pharmaceuticals in Japan by Source of Ingredients, 1980-83

(in billions of yen)

	1980		1981		1982		1983	
	Value	Share	Value	Share	Value	Share	Value	Share
Total Production	Y3,482.2	100.0%	Y3,679.1	100.0%	Y3,980.2	100.0%	Y4,032.1	100.0%
Prescription Drugs	2,978.4	85.5	3,135.7	85.2	3,406.5	85.6	3,438.6	85.3
Domestic Drugs	1,981.3	56.9	2,161.2	58.7	2,339.0	58.8	2,382.6	59.1
Imported Drugs	997.2	28.6	974.5	26.5	1,067.5	26.8	1,056.0	26.2
Nonprescription Drugs	503.7	14.5	543.4	14.8	573.7	14.4	593.5	14.7
Antibiotics and Anti-infectives	814.3	100.0	780.1	100.0	865.2	100.0	735.9	100.0
Prescription Drugs	814.3	100.0	780.1	100.0	865.2	100.0	735.9	100.0
Domestic Drugs	425.9	52.3	422.8	54.2	474.9	54.9	417.6	56.7
Imported Drugs	388.5	47.7	357.3	45.8	390.2	45.1	318.3	43.3
Nonprescription Drugs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Antitumor Agents, Hormones and Miscellaneous Metabolic Agents	560.6	100.0	577.0	100.0	591.9	100.0	593.6	100.0
Prescription Drugs	451.1	80.5	449.1	77.8	467.4	79.0	463.4	78.1
Domestic Drugs	339.6	60.6	349.9	60.6	369.2	62.4	358.1	60.3
Imported Drugs	111.6	19.9	99.2	17.2	98.2	16.6	105.3	17.7
Nonprescription Drugs	109.5	19.5	127.9	22.2	124.5	21.0	130.2	21.9
Cardiovascular Agents	377.8	100.0	438.0	100.0	440.3	100.0	509.2	100.0
Prescription Drugs	361.7	95.8	423.0	96.6	425.7	96.7	495.5	97.3
Domestic Drugs	224.4	59.4	268.2	61.2	282.7	64.2	316.8	62.2
Imported Drugs	137.3	36.3	154.9	35.4	143.0	32.5	178.7	35.1
Nonprescription Drugs	16.0	4.2	15.0	3.4	14.6	3.3	13.7	2.7
Central and Peripheral Nervous System Agents	424.5	100.0	437.2	100.0	468.4	100.0	475.3	100.0
Prescription Drugs	351.4	82.8	357.1	81.7	376.2	80.3	385.3	81.1
Domestic Drugs	199.2	46.9	207.9	47.6	201.6	43.0	210.4	44.3
Imported Drugs	152.2	35.9	149.2	34.1	174.6	37.3	174.9	36.8
Nonprescription Drugs	73.1	17.2	80.1	18.3	92.3	19.7	90.1	19.0
Vitamins, Nutrients, Tonics and Alternatives	302.0	100.0	338.6	100.0	384.6	100.0	396.4	100.0
Prescription Drugs	248.4	82.3	278.5	82.3	314.6	81.8	315.5	79.6
Domestic Drugs	216.1	71.6	247.9	73.2	277.7	72.2	285.3	72.0
Imported Drugs	32.3	10.7	30.6	9.0	36.9	9.6	30.2	7.6
Nonprescription Drugs	53.6	17.7	60.0	17.7	70.0	18.2	81.0	20.4
Gastrointestinal and Genitourinary Agents	291.4	100.0	318.2	100.0	363.0	100.0	381.5	100.0
Prescription Drugs	206.9	71.0	228.5	71.8	271.2	74.7	282.8	74.1
Domestic Drugs	174.9	60.0	188.9	59.4	200.0	55.1	194.4	51.0
Imported Drugs	32.1	11.0	39.6	12.4	71.1	19.6	88.3	23.1
Nonprescription Drugs	84.5	29.0	89.8	28.2	91.9	25.3	98.8	25.9

Note: Imported prescription drugs are compounds made primarily from imported ingredients, including raw powder, undiluted solutions and bulk goods.

Source: Ministry of Health and Welfare, Pharmaceutical Affairs Bureau

Table 4: R&D Spending by Japan's Pharmaceutical Industry, FY 1979-FY 1983

	FY 1979	FY 1980	FY 1981	FY 1982	FY 1983
Total Expenditures (in billions of yen)	Y176.9	Y189.8	Y218.4	Y239.8	Y289.9
Total Expenditures (in million of dollars*)	$770.3	$873.8	$960.1	$960.7	$1,226.7
Percent of Sales	5.5%	5.5%	5.9%	5.6%	6.6%

*The following average annual exchange rates were used to convert the yen figures into dollars: FY 1979, Y229.66; FY 1980, Y217.25; FY 1981, Y227.52; FY 1982, Y249.64; and FY 1983, Y236.33.

Source: Management and Coordination Agency, Statistics Bureau, Report on the Survey of Research and Development 1984

Total 5 R&D Spending by Japanese Pharmaceutical Companies by Sales Volume, FY 1983

Sales Volume (million yen)	Number of Companies	Total Sales (million yen)	Total Operating Income (million yen)	Total R&D Personnel	Total R&D Spending (million yen)	Percent of Sales
Total	438	Y4,398,200	Y455,651	21,375	Y289,896	6.6%
Under Y100	17	700	68	44	69	9.6
Y100-Y1,000	191	83,100	6,935	616	2,419	2.9
Y1,000-Y10,000	161	562,300	51,326	3,331	27,635	4.9
Y10,000 or More	69	3,752,100	397,322	17,384	259,774	6.9

Source: Management and Coordination Agency, Statistics Bureau, Report on the Survey of Research and Development 1984

Table 6: Nature of R&D Spending by Japanese Pharmaceutical Companies by Size of Capital, FY 1983

Capital (million yen)	Number of Companies	R&D Spending (million yen)				Distribution		
		Total	Basic	Applied	Development	Basic	Applied	Development
Total	435	Y289,896	Y51,543	Y70,655	Y167,698	17.8%	24.4%	57.8%
Y5-Y10	63	390	14	7	368	3.7	1.8	94.5
Y10-Y100	235	15,518	3,082	3,925	8,512	19.9	25.3	54.9
Y100-Y1,000	89	46,248	12,579	9,728	23,941	27.2	21.0	51.8
Y1,000-Y10,000	38	128,073	19,161	32,985	75,928	15.0	25.8	59.3
Y10,000 or More	10	99,668	16,708	24,011	58,949	16.8	24.1	59.1

Source: Management and Coordination Agency, Statistics Bureau, Report on the Survey of Research and Development 1984

Table 7: Financial Profiles of Major Japanese Pharmaceutical Makers, FY 1982-FY 1984

(in millions of yen)

	Worldwide Pharmaceutical Sales	Total Sales	Percent of Non-Japan Sales	Total Operating Income	Total R&D Spending	Percent of Total Sales
Takeda Chemical Industries, Ltd.						
FY 1982	Y290,829	Y469,079	6%	Y43,089	n.a.	n.a.
FY 1983	291,667	478,143	7	40,274	Y28,800	6.0%
FY 1984	289,659	474,852	7	36,135	28,800	6.1
Sankyo Co., Ltd.						
FY 1982	181,433	221,260	1	24,446	n.a.	n.a.
FY 1983	192,909	232,421	1	24,277	14,500	6.2
FY 1984	201,803	243,136	1	22,729	15,900	6.5
Fujisawa Pharmaceutical Co., Ltd.						
FY 1982	198,605	198,605	5	25,618	n.a.	n.a.
FY 1983	203,757	203,757	5	19,908	17,800	8.7
FY 1984	196,675	196,675	5	13,894	18,700	9.5
Shionogi & Co., Ltd.						
FY 1982	130,358	181,053	1	23,361	n.a.	n.a.
FY 1983	124,111	177,302	2	22,296	15,000	8.5
FY 1984	127,653	185,005	2	19,154	16,000	8.6
Eisai Co., Ltd.						
FY 1982	99,650	127,757	7	19,165	n.a.	n.a.
FY 1983	108,268	135,335	6	18,776	15,100	11.2
FY 1984	108,318	135,398	7	15,067	16,200	12.0
Yamanouchi Pharmaceutical Co., Ltd.						
CY 1982	94,540	94,540	0	14,669	n.a.	n.a.
CY 1983	104,804	104,804	0	15,467	10,000	9.5
CY 1984	107,511	107,511	5	15,092	10,700	10.0
Tanabe Seiyaku Co., Ltd.						
FY 1982	98,897	135,475	7	16,194	n.a.	n.a.
FY 1983	104,494	143,143	8	14,121	10,600	7.4
FY 1984	105,382	148,426	12	13,304	12,400	8.4

Note: Data on a fiscal year basis can be converted into dollars using the following exchange rates: FY 1982, Y249.64; FY 1983, Y236.33; and FY 1984, Y244.19. For calendar year exchange rates, see Table 1.

Source: Toyo Keizai Shinposha, Kaisha Shikiho (Company Quarterly Report)

Table 8: U.S. Pharmaceutical Market, 1980-84

(in millions of dollars)

	1980	1981	1982	1983	1984
Shipments	$17,674.3	$20,041.7	$22,955.1	$25,653.1	$27,617.5
Total Exports (f.a.s.)	2,045.6	2,281.5	2,378.9	2,618.2	2,749.3
Total Imports (Customs/f.a.s.)	916.7	1,020.6	1,078.3	1,311.9	1,662.0
Trade Balance	1,128.9	1,260.9	1,300.6	1,306.3	1,087.3
Exports to Japan (f.a.s.)	334.1	441.2	501.4	532.4	559.3
Imports from Japan (Customs/f.a.s.)	111.8	135.1	125.5	162.0	162.3
Trade Balance	222.3	306.1	375.9	370.4	397.0
Total Exports as Percent of Shipments	11.6%	11.4%	10.4%	10.2%	10.0%
Total Imports as Percent of Apparent Domestic Consumption	5.5%	5.4%	5.0%	5.4%	6.3%
Exports to Japan as Percent of Shipments	1.9%	2.2%	2.2%	2.1%	2.0%
Imports from Japan as Percent of Apparent Domestic Consumption	0.7%	0.7%	0.6%	0.7%	0.6%

Table 9: U.S. Shipments of Pharmaceuticals, 1980-84

(in millions of dollars)

	1980	1981	1982	1983	1984
Central Nervous System Agents	$2,821.0	$3,282.6	$3,841.4	$4,439.0	$4,995.1
Antibiotics and Other Anti-infectives	1,778.3	2,081.9	2,438.0	2,820.2	3,034.8
Cardiovascular Agents	1,176.4	1,397.1	1,842.5	2,264.2	2,680.8
Vitamins and Nutrients	1,876.5	2,042.6	2,170.8	2,454.8	2,279.7
Hormones and Antitumor Agents	1,209.7	1,420.5	1,705.3	1,885.7	1,946.5
Respiratory System Agents	1,239.5	1,437.5	1,590.1	1,750.4	1,877.0
Gastrointestinal and Genitourinary Agents	1,232.3	1,381.5	1,419.5	1,611.7	1,695.0
Dermatological Agents	728.1	787.0	819.1	1,037.7	1,103.7
Veterinary Preparations	546.3	605.0	789.0	847.2	856.7
Unspecified Preparations	306.2	352.0	393.4	456.2	491.2
Pharmaceutical Preparations	12,914.3	14,787.7	17,009.1	19,567.1	20,960.5
of which:					
Prescription	7,814.2	8,976.6	10,591.2	12,221.0	13,363.3
Nonprescription	4,530.2	5,143.1	5,316.6	6,318.1	6,547.0
Bulk Shipments	263.8	315.9	387.4	571.9	558.8
Biologicals*	1,602.0	1,857.0	2,293.0	2,581.0	3,187.0
Medicinals and Botanicals**	3,158.0	3,397.0	3,653.0	3,505.0	3,470.0
Total Shipments	17,674.3	20,041.7	22,955.1	25,653.1	27,617.5

*Biologicals include vaccines, antigens, antitoxins and toxoids as well as serums, plasmas and other blood derivatives.

**Medicinals and botanicals are largely made up of bulk shipments.

Sources: Department of Commerce, Bureau of the Census, Current Industrial Reports: Pharmaceutical Preparations, Except Biologicals (data on pharmaceutical preparations); Department of Commerce, Bureau of the Census, Annual Survey of Manufactures (data on biologicals and medicinals and botanicals, 1980-83); Department of Commerce estimates (data on biologicals and medicinals and botanicals, 1984).

Table 10: R&D Spending by the U.S. Pharmaceutical Industry, 1980-83*

	1980	1981	1982	Budgeted 1983
Total Expenditures	$1,976.7	$2,339.5	$2,773.7	$3,259.6
Company-Financed Expenditures	1,971.6	2,335.3	2,770.6	3,257.7
Spent in United States	1,544.1	1,866.2	2,265.6	2,657.3
Spent Abroad	427.5	469.1	505.0	600.4
U.S. Government Grants and Contracts for Company-Conducted R&D	5.1	4.2	3.1	1.9
Total Sales	22,513.0	23,530.0	25,654.0	28,317.0
R&D Expenditures as Percent of Sales	8.8%	9.9%	10.8%	11.5%

*Figures apply to member companies of the Pharmaceutical Manufacturers Association only. These 131 companies account for over 90 percent of the U.S. industry's sales of prescription drugs and over-the-counter professional products.

Source: Pharmaceutical Manufacturers Association, 1980-1983 Annual Survey Report

Table 11: Distribution of R&D Money Spent in the United States by Product Class, 1980-82

	1980	1981	1982
Total Expenditures (in millions of dollars)	$1,544.1	$1,866.2	$2,265.6
Anti-infectives	17.4%	16.9%	16.3%
Central Nervous System and Sense Organs	16.2	14.6	14.1
Cardiovasculars	18.9	19.5	20.9
Neoplasms, Endocrine System and Metabolic Dieseases	14.3	15.9	17.7
Gastrointestinal and Genitourinary System	6.4	5.3	5.3
Respiratory	4.8	4.7	5.0
Biologicals	3.1	2.4	2.3
Dermatologicals	3.2	2.7	2.4
Vitamins	2.3	1.8	1.8
Diagnostic (in vitro)	1.0	1.4	1.3
Other	6.9	9.4	8.1
Veterinary Preparations	5.1	4.8	4.3
Veterinary Biologicals	0.4	0.6	0.5
Total	100.0	100.0	100.0

Source: Pharmaceutical Manufacturers Association, 1980-1983 Annual Survey Report

Table 12: Distribution of R&D Money Spent in the United States by Function, 1980-82

	1980	1981	1982
Total Expenditures (in millions of dollars)	$1,544.1	$1,866.2	$2,265.6
Clinical Evaluation: Phases I, II, III	19.8%	19.7%	19.9%
Biological Screening and Pharmacological Testing	18.6	18.5	17.9
Synthesis and Extraction	15.4	11.9	11.6
Pharmaceutical Dosage Formulation and Stability Testing	9.2	9.8	10.4
Toxicology and Safety Testing	9.7	9.5	8.9
Process Development for Manufacturing and Quality Control	9.0	9.4	9.5
Clinical Evaluation: Phase IV	3.7	3.1	3.2
Regulatory and Preparation, Submission and Processing of Applications	4.1	3.7	3.9
Bioavailability Studies	2.1	2.7	2.8
Other	8.4	11.7	11.9
Total	100.0	100.0	100.0

Source: Pharmaceutical Manufacturers Association, 1980-1983 Annual Survey Report

Table 13. Financial Profiles of Major U.S. Manufacturers of Prescription Pharmaceuticals

(in millions of dollars)

	Worldwide Pharmaceutical Sales	Total Sales	Percent of Non-U.S. Sales	Worldwide Pharmaceutical Operating Income	Total Operating Income	Total R&D Spending	Percent of Total Sales
Merck & Co., Inc.							
1982	$2,425.1	$3,063.0	44%	$544.0	$598.5	$320.2	10.5%
1983	2,640.5	3,246.1	43	667.9	692.3	356.1	11.0
1984	2,917.8	3,559.7	43	724.2	779.3	393.1	11.0
American Home Products Corp.							
1982	2,075.4	3,971.7	28	647.3	985.9	134.9	3.4
1983	2,278.1	4,273.3	26	713.9	1,079.7	158.8	3.7
1984	2,416.8	4,485.5	23	765.5	1,174.5	183.7	4.1
Pfizer Inc.							
1982	1,694.0	3,496.0	49	n.a.	620.9	199.4	5.7
1983	1,806.0	3,750.0	45	n.a.	798.4	227.2	6.1
1984	1,891.0	3,854.5	41	n.a.	875.2	252.3	6.6
Eli Lilly and Co.							
1982	1,535.2	2,962.7	36	n.a.	706.9	267.4	9.0
1983	1,645.8	3,033.7	34	n.a.	792.2	293.6	9.7
1984	1,664.1	3,109.2	32	n.a.	813.9	341.3	11.0
Bristol-Myers Co.							
1982	1,360.2	3,599.9	28	294.8	656.9	161.0	4.5
1983	1,505.0	3,917.0	26	318.7	747.3	185.3	4.7
1984	1,586.6	4,189.4	25	336.3	808.7	212.4	5.1
SmithKline Beckman Corp.							
1982	1,359.5	2,642.8	34	n.a.	670.0	222.1	8.4
1983	1,478.2	2,835.4	33	n.a.	708.2	264.7	9.3
1984	1,542.2	2,949.2	32	n.a.	705.0	279.2	9.5
Abbott Laboratories							
1982	n.a.	2,602.4	32	n.a.	512.0	137.0	5.3
1983	1,423.0	2,927.9	30	n.a.	626.0	184.5	6.3
1984	1,554.0	3,104.0	30	n.a.	704.0	218.7	7.1
Warner-Lambert Co.							
1982	1,286.0	2,971.0	45	284.0	477.0	145.0	4.9
1983	1,405.0	3,108.0	41	328.0	503.0	175.0	5.6
1984	1,409.0	3,167.0	40	339.0	523.0	195.0	6.2
Johnson & Johnson							
1982	1,118.6	5,760.9	43	314.7	787.2	363.2	6.3
1983	1,175.8	5,972.9	40	345.6	724.1	405.1	6.8
1984	1,295.7	6,124.5	39	427.0	755.1	421.2	6.9
Upjohn Co.							
1982	1,084.0	1,835.6	38	n.a.	197.0	195.8	10.7
1983	1,173.0	1,993.2	36	n.a.	251.5	229.2	11.5
1984	1,272.0	2,188.2	34	n.a.	282.9	258.2	11.8
Squibb Corp.							
1982	978.3	1,660.8	35	122.4	209.5	123.0	7.4
1983	1,045.1	1,768.9	32	186.2	255.6	141.7	8.0
1984	1,089.7	1,880.0	28	207.3	290.7	150.7	8.0
Schering-Plough Corp.							
1982	944.7	1,729.2	48	179.1	289.3	125.6	7.3
1983	996.0	1,808.5	45	186.3	307.6	144.7	8.0
1984	1,056.8	1,874.3	43	203.9	324.1	163.6	8.7

Note: Depending on how a company breaks out its business segments, the figures for pharmaceutical sales might include products other than prescription pharmaceuticals. For no company, though, do the figures reflect sales of nonprescription drugs.

Source: Company annual reports

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Congressional Conference Discusses Exchange Rates

About one hundred bankers, economists, lawmakers and government officials from major industrial countries attended last week's congressional conference on exchange rates in Washington. The November 12-13 meeting, attended by Treasury Secretary James Baker and Deputy Treasury Secretary Richard Darman and co-sponsored by Rep. Jack Kemp (R, N.Y.) and Sen. Bill Bradley (D, N.J.), reflects growing congressional concern over the high value of the dollar and its effect on the U.S. economy.

preliminary budget guidelines. Usually, this is followed by intense JDA lobbying and results in slightly higher final figures from the tight-fisted Finance Ministry. Last-minute intervention by Prime Minister Yasuhiro Nakasone to raise defense allocations has also been part of the annual drama in recent years.

If previous experience is any guide, MOF will settle on a spending hike of about 6 percent, just under the 7 percent figure sought by JDA. The prime minister may again step in to boost the number by a few tenths of a percent. The new budget figure is especially significant because it is the first installment in the new five-year plan. Japanese defense budget analysts agree that annual average increases of at least 6 percent will be needed to meet the agency's goals.

The previous five-year program was heavily criticized by some American observers -- despite its status as only a planning document -- because it was considered inadequate to meet defense policy goals, such as the 1,000-mile sealane defense. Furthermore, funding was deemed insufficient to meet the majority of the acquisition goals defined in the program. (Roughly 40 percent of the program was completed when JDA began developing new targets.) Anything much less than a 7 percent increase would start the new program off on the wrong foot and could bring another outcry about Japan's "free ride."

MOF officials may hope to capitalize on recent defense policy debates in the Diet and the unusually strong public reaction to intimations that the budget may breach the one percent barrier. The ministry has been a key force in restricting defense spending in the past and remains committed to its tight budget policies. Viewed in that light, the press leak assumes a slightly different character, suggesting that MOF may indeed seek to reduce JDA's preliminary increase by almost half.

Michael W. Chinworth

Japan's Stake In The Philippines

Continued signs of political instability in the Philippines have caused growing concern among Japanese government officials. Although not yet fearful of an outright revolution, officials are aware that rising internal disputes coupled with stagnant economic performance could spill over into Southeast Asia and have a serious long-term impact on Japanese interests, ranging from regional and bilateral trade to larger security issues. Among these are:

- Impact on ASEAN - Turmoil within the Philippines could easily erode the economic and political viability of the Association of Southeast Asian Nations by weakening its internal cohesion. Like the United States, the Japanese government has looked to ASEAN to serve as both an economic stimulus for the region and as a politically stabilizing agent. A weakened ASEAN could result in reduced Southeast Asian markets for Japan. Moreover, the organization might be forced to turn to Tokyo for greater economic assistance should it find one of its members foundering.

Some observers have argued that the American military presence in the region has enabled ASEAN nations to remain uncommitted in security terms to other powers in the area, or to remain close to the United States. A reduced U.S. military presence through the loss of U.S. bases in the Philippines, they argue, would eliminate this option for some and could necessitate closer ties with the People's Republic of China or even the Soviet Union.

- Foreign Assistance - The Philippines has ranked among the top ten recipients of Japan's foreign aid over the last five years and continues to figure prominently in aid plans. Japan has cooperated with the Philippines to a certain degree in aid projects and in other financial areas -- restructuring Philippine debts, for example -- but the Marcos government seeks more assistance. The president's wife, Imelda Marcos, recently visited Japan to urge officials to boost Japan's commitments to Manila.

Aid to the Philippines has increased from $137 million in 1982 to $160 million in 1984 (down from $210 million in 1981 but still comparable to the $180 million in direct military and economic aid from the United States). Steady and measured increases are likely, but rather than risk being identified with the old regime should a dramatic -- and possibly negative -- change in government occur, the rate increases are not likely to exceed the levels of the last three years. Furthermore, regional diversification has been a key element of recent Japanese aid strategies, and Tokyo is not expected to reverse the trend.

Japan's Aid to the Philippines, 1980-84

(in millions of dollars)

Year	Amount	Rank
1980	$94.0	6
1981	210.0	4
1982	137.0	5
1983	147.0	4
1984	160.0	5

- Investment and Trade - Japanese companies have invested $832 million in the Philippines. Although the amount is small in contrast to Japan's investments in other nations, it is perhaps this stake that is the most vulnerable. Although it is officially denied, firms in remote areas are said to be paying what amounts to protection fees to local rebels in return for relatively unrestricted operations. Rebel forces are strong in certain regions and are said to be capable of disrupting corporate operations under present conditions. A rebel-backed government, presumably, could do more, including nationalize foreign-affiliated firms.

Japan is the Philippines' largest trading partner after the United States. Two-way trade totaled $2.5 billion in 1984, with the Philippines providing primarily raw materials (iron ore, lumber, nonferrous metal scrap), while Japan exported manufactured goods. Total trade has declined steadily over the years, due to significant drops in Japanese exports to the Philippines.

Accounting for only 0.6 percent of Japan's total exports and 1 percent of its imports, the Philippines is not important in terms of overall Japanese trade, but analysts view the trade relationship as significant if only because of the Philippines' continued economic problems and its implications for ASEAN trade relations. Furthermore, given the Philippines' resource base, there is potential for sustained and perhaps expanded trade ties if political problems do not impact negatively on bilateral relations.

The Japanese government would certainly try to remain flexible in order to permit continued trade ties in the event of a change of government. While an ouster of the Marcos government might cause trade with Japan to falter, more moderate transformations might not produce any noticeable changes in trade relations.

Japan's Direct Investment in the Philippines, FY 1980-84

(in millions of dollars)

FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	Total March 31, 1985
$78.0	$72.0	$34.0	$65.0	$46.0	$832.0

Japan's Trade with the Philippines, 1980-85

(in millions of dollars)

	Exports	Imports	Two-Way Trade
1980	$1,951.4	$1,683.3	$3,634.7
1981	1,731.2	1,928.3	3,658.5
1982	1,576.2	1,803.0	3,379.2
1983	1,306.5	1,743.6	3,050.1
1984	1,418.6	1,079.9	2,498.5
1984 January-September	1,103.3	775.8	1,879.1
1985 January-September	969.7	522.0	1,491.7

- Security - Critical long-term considerations for Japan in the Philippines focus on security issues. Although the loss of American bases there is still unlikely, that worst-case scenario has been considered more seriously in recent months. A U.S. withdrawal could mean a corresponding increase in Soviet naval power in the region. With a base of operations in Vietnam, the Russian navy would have greater room to maneuver in the Indian Ocean and South China Sea.

Rep. Stephen Solarz (D, N.Y.), chairman of the House Foreign Affairs Subcommittee on Asian Affairs, noted recently that Japan and other Asian nations should feel secure that "the United States will not retreat to

Honolulu" and abandon its Pacific power status. While total U.S. force levels might not be reduced in such a case, however, the actual geographic reach of American military influence in the region would decline. Furthermore, the need to construct new facilities or expand existing ones could mean a serious shift of U.S. resources in the region, leading one specialist to suggest that for a few critical years, the ability of the United States to maintain an effective presence in northeast Asia would be reduced.

It is highly possible that Tokyo would face pressures to accelerate its defense spending, particularly in the realm of defending the sealanes approaching Japan, should the United States be forced to withdraw from or reduce its presence in the Philippines. Yet it is politically and economically unlikely that the country would be in any position to accelerate its defense spending sufficiently to meet that contingency.

Although the Marcos government remains far from the point of collapse, the situation is serious enough to cause concern. Japanese officials, however, are hesitant to assume a high profile in the country for fear of a negative reaction and accusations that it is trying to influence internal affairs.

Michael W. Chinworth

U.S. Policy Could Plunge Global Shipping Into Hot Water

The Reagan administration continues to roil the waters of the global shipping industry by insisting on free-market mechanisms when subsidization and regulation are the norms. The situation is exacerbated by a global oversupply of shipping and shipbuilding capacity that has spurred other nations to even greater interference in the marketplace. Armed with legislation granting retaliatory powers, the administration is threatening to step up its free-trade efforts and upset the carefully laid plans of foreign shippers.

The strategic nature of sea transport and shipbuilding capability has long been recognized. The use of building and operating subsidies and domestic flag laws arose in developing and industrialized countries for opposite reasons. Developing nations employed such schemes to create and to protect infant shipping firms from harsh international competition. Industrialized nations, on the other hand, also adopted these practices to fend off the challenge of low-wage nations and preserve a minimum of shipping capacity for national security reasons. The two sides appeared to have hammered out a compromise in 1982 when the United Nations submitted a new Law of the Sea treaty that permits nations to reserve specific percentages of commercial cargo for national merchant fleets above and beyond existing government requirements. Japan and Europe signed the treaty in 1982, but the United States remains adamantly opposed to any reservation schemes for liner service.

Since 1982, the Consultative Shipping Group has served as a forum for the United States, Japan and Europe to work out their differences on a new international liner code. With negotiations making little progress, Congress passed the Shipping Act of 1984 hoping to strengthen the administration's bargaining hand. Section 13(B)(5) of the act gives the Federal Maritime Commission the power to retaliate against restrictive foreign shipping practices. With this sword in hand, the administration took an even harder line against cargo reservation systems by insisting on November 13 that U.S.

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REPORT

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JAPAN'S HIGH SAVING RATE: AN OVERVIEW

Summary

Japan's rate of saving, despite a modest decline since the first oil shock, remains high by international standards. While this high level is credited with playing a crucial role in Japan's economic development, it has been criticized as the underlying cause of its huge trade surplus. Abundant household saving, exceeding business investment and the government budget deficit, has led to large capital outflows, reducing the value of the yen and increasing Tokyo's trade surplus.

The rise in Japan's saving rate from low levels following World War II is a result of rising income and demographic changes. The high cost of housing is another factor. Moreover, the tax system encourages saving, in contrast to the United States, where it favors consumption.

Introduction

Japan's gross saving as a percentage of gross domestic product rose during the 1960s, peaking at 40.2 percent in 1970 (see Table 1). Although the level has fallen since the first oil shock, the 1983 rate of 30.3 percent was more than 50 percent above the average for the 24 member countries of the Organization for Economic Cooperation and Development and about double the U.S. figure of 15.2 percent. According to Henry Rosovsky of Harvard University, "Both as individuals and as a nation, the Japanese have demonstrated an unusual willingness to forego present consumption for larger or more important benefits in the future."

Table 1: Gross Saving as a Percentage of GDP

	1965	1970	1975	1980	1981	1982	1983
United States	21.0%	18.1%	17.4%	18.3%	19.0%	15.9%	15.2%
Japan	31.9	40.2	32.2	31.9	31.7	30.8	30.3
Germany	27.2	28.1	20.8	22.3	20.7	20.9	21.8
France	25.7	26.2	23.0	22.2	19.8	18.6	18.6
United Kingdom	20.2	22.1	15.9	18.5	17.5	18.6	18.1
Italy	23.6	24.2	20.1	22.5	19.0	18.5	17.5
Canada	23.0	21.2	21.1	22.9	22.4	19.0	19.2
Average for above countries	22.9	23.0	20.8	21.9	21.5	19.6	19.2
Average for all OECD countries	23.2	23.4	21.2	21.8	21.4	19.6	19.3

Source: Organization for Economic Cooperation and Development, Economic Outlook, June 1985.

Business investment in Japan increased by an average annual real rate of 14.4 percent between 1952 and 1973. By financing this extraordinarily high level of capital formation, Japan's saving rate played a key role in the country's postwar economic growth. During the past 20 years, gross fixed capital formation averaged 32.3 percent of GDP in Japan, compared to the OECD average of 21.5 percent and a U.S. share of only 18.1 percent.

There is no evidence that the saving differential between Japan and the United States is narrowing. According to a July 1985 Bank of Japan survey, household saving was up 6.5 percent over a year ago, despite an increase of only 1.6 percent in take-home income. In contrast, U.S. personal saving as a share of disposable income fell to 1.9 percent in September 1985, an all-time low. The U.S. saving rate for the third quarter of 1985 was 2.9 percent, less than one-half the level of the past 10 years.

As Japan's trade surplus has grown, Western critics have zeroed in on the high saving rate, arguing that it contributes to the large capital flows that have weakened the yen. By restraining domestic demand, household saving has slowed imports and forced producers to concentrate on exports, this argument goes. The high rate of household saving is also blamed for increasing the government's budget deficit and lowering the country's standard of living.

Historical Overview

Japan's saving rate has not always been high; net national saving as a share of GNP is estimated to have been only 3.4 percent during the period 1887 to 1906. Moreover, Japan borrowed little from overseas, wary of following China's example by relying on foreign capital. But domestic saving rose in

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step with investment during the prewar years, reaching 9.7 percent of GNP from 1927 to 1936, and financed the investment spurts responsible for Japan's accelerating growth rate.

Saving rates were low after the war, as real income was reduced to a near-subsistence level. Once inflation was brought under control in 1951 and real income began to rise, savings rose steadily (see Table 2). Households saved to restore their financial position, which had been reduced by inflation following the war, and the business sector saved to rebuild the capital stock, which was small relative to both the United States and the prewar level. While the rate was expected to level off once the economy returned to its prewar position, it unexpectedly continued to rise during the 1960s, although at a slower pace.

Table 2: Japan's Saving and Investment, 1952-69

	Gross Private Saving*			Household Saving**	Gross Private Investment*
	Total	Corporate	Household		
1952-54	16.5%	7.4%	9.1%	9.2%	17.2%
1955-57	22.8	9.2	13.5	14.2	21.8
1958-60	24.9	11.0	13.9	16.4	24.3
1961-63	27.2	12.6	14.6	18.6	27.2
1964-66	26.6	12.5	14.1	17.2	25.5
1967-69	30.6	14.9	15.8	19.3	29.9

*As a percentage of GNP.
**As a percentage of disposable income.

Sources: Edward F. Denison and William K. Chung, "Economic Growth and Its Sources," in Asia's New Giant (Washington, D.C.: The Brookings Institution, 1976), p. 117; Economic Planning Agency, Annual Reports on National Accounts.

Table 3 shows saving by sector based on national income and product accounts data. Household saving has declined by almost one-fourth since the first oil shock, but remains at a high level. Business investment, which fell sharply at the same time, has stabilized at about 20 percent of GNP. The government, which, prior to 1973, contributed importantly to total saving by collecting more taxes than it spent on public consumption, ran increasing deficits during the second half of the 1970s. The increasing burden of government debt has led Tokyo to adopt a policy of reduced growth in government spending since 1979.

It can be shown using national accounting identities that a nation's current account balance equals the difference between domestic saving and investment (see JEI Report No. 35A, September 13, 1985). When domestic investment and the government budget deficit do not absorb private saving, the excess is invested overseas. That capital outflow must be offset by a

Table 3: Japan's Saving-Investment Balance

(percent of GNP)

A. Saving and Investment

	FY 1970	FY 1975	FY 1976	FY 1977	FY 1978	FY 1979	FY 1980	FY 1981	FY 1982	FY 1983
1. Household Saving	12.0%	16.7%	15.9%	15.6%	14.3%	13.7%	13.9%	14.1%	12.5%	12.7%
2. Private Investment	30.7	23.4	22.9	21.4	21.4	23.1	22.9	21.9	21.1	20.1
3. Government Balance	1.9	-3.6	-3.5	-4.1	-4.1	-4.4	-4.0	-3.7	-3.5	-3.0
a. Central Government	0.0	-4.0	-4.3	-5.0	-4.9	-5.7	-5.5	-5.4	-5.4	-5.0
b. Social Security	2.3	2.5	2.4	2.8	2.5	2.7	2.8	2.9	2.9	2.7
c. Local Government	-0.4	-2.2	-1.6	-1.8	-1.7	-1.4	-1.3	-1.3	-1.0	-0.7

B. Net Lending and Current Account by Sector

	FY 1970	FY 1975	FY 1976	FY 1977	FY 1978	FY 1979	FY 1980	FY 1981	FY 1982	FY 1983
1. Household Sector	8.2	10.8	10.0	10.0	8.7	8.8	10.4	11.4	9.6	10.8
2. Corporate Sector	-8.2	-8.0	-6.0	-4.7	-3.8	-5.9	-6.9	-7.2	-5.7	-5.4
3. Private Balance (1-2)	0.0	2.8	4.0	5.3	4.9	2.9	3.4	4.1	3.9	5.3
4. Government Balance	1.9	-3.6	-3.5	-4.1	-4.1	-4.4	-4.0	-3.7	-3.5	-3.0
5. Total Balance (3+4)	1.8	-0.8	0.5	1.2	0.8	-1.5	-0.6	0.4	0.4	2.3
6. Current Account	1.2	0.1	0.9	1.9	1.3	-1.3	-0.5	0.7	1.0	2.2

Source: Economic Planning Agency, Annual Report on National Accounts, 1985 corresponding current account surplus. A current account deficit occurs when domestic investment and the government deficit exceed private saving. The shortage of domestic saving is offset by an inflow of capital from abroad that matches the current account deficit.

Table 3 also shows net lending -- saving minus investment -- by sector. The household sector remains a net creditor to the rest of the economy. Prior to the first oil shock, the large pool of surplus savings generated by households was absorbed by the business sector. As growth decelerated after 1973 and investment and net borrowing by the business sector declined, the government absorbed the surplus savings of the household sector. Its policy of fiscal austerity since 1979, in the face of continued high household saving and stable investment, has contributed to a substantial excess of domestic saving, leading to capital outflows, an undervalued yen and large trade surpluses.

In contrast, the United States has had an extremely expansionary fiscal policy since its last current account surplus in 1981. The increase in the total government deficit to 3.4 percent of GNP in 1984, combined with a recovery in private investment to 1978-79 levels and continued low personal saving of 4.3 percent, has resulted in a current account deficit equal to 2.8 percent of GNP.

Business Saving

Although it has received less attention, the saving performance of Japan's corporations has also been impressive. Business saving, which consists of retained profits and depreciation, doubled from 7.4 percent of GNP in the 1952-54 period to 14.9 percent by 1967-69. The rapid growth of Japan's economy in the 1950s and 1960s, the rise in the price of labor relative to the price of capital, and repeated reductions in corporate tax rates encouraged firms to save and invest. In 1971, Japan's ratio of capital to labor inputs was 3.5 times larger than in 1953.

In 1970, the business sector's savings in Japan were substantially higher than the United States'. The differential can be attributed in part to lower corporate tax rates, equivalent to about one-third of pretax profits, and smaller dividend payments in Japan. The gap between business saving in the two countries has been reduced in recent years, as the deceleration of economic growth since 1974 has substantially weakened the incentive to invest in Japan. Moreover, the corporate tax burden has increased in Japan and declined in the United States. According to Nihon Keizai Shimbun, the corporate tax burden in FY 1984 rose to 55.6 percent of pretax profits in Japan compared to 37.4 percent in the United States.

Household Saving

The role of the household sector in providing abundant and inexpensive capital to the industrial sector is often cited as a key factor in Japan's postwar economic development. Household saving has been extraordinary, both in terms of its rapid increase since the 1950s and its remarkably high rate.

Table 4 compares personal saving as a share of disposable personal income (personal income minus tax payments) for four countries. The rate in Japan is about 3.5 times higher than in the United States and substantially above the figures for the United Kingdom and Germany. In contrast to the United States, Japan's household saving accounts for a larger proportion of total saving and its share is rising. Comparing 1970-72 to 1981-83, household saving as a share of gross private saving rose from 37 percent to 48 percent in Japan, while the same ratio in the United States fell from 32 percent to 25 percent.

Table 4: Personal Saving as a Percentage of Disposable Income

	United States	Japan	Germany	United Kingdom
1970	8.0%	18.2%	14.6%	9.3%
1979	5.9	18.7	13.9	14.1
1980	6.0	19.2	14.2	15.2
1981	6.7	19.7	14.9	13.5
1982	6.2	17.6	14.2	12.9
1983	5.0	17.3	12.7	10.9

Source: Department of Commerce, International Economic Indicators

Some observers have attributed the high saving rate to the Japanese cultural heritage, which encouraged nonmaterial values and slowed the rise in consumer expectations. In modern postwar Japan, however, saving rates are far greater than those recorded in the prewar years, casting doubt on the validity of cultural characteristics as an explanation.

The rapid growth of the economy is regarded as both a consequence and a cause of Japan's high saving rate. The "virtuous circle" of saving and investment leading to higher levels of income led in turn to a further increase in saving. While the rise in income from subsistence levels following the war permitted households to increase their rate of saving in the early 1950s, it is less clear why consumers would continue to raise the percentage of income saved once income had regained prewar levels. In the United States, for example, the rate of saving has been constant over time despite rising incomes.

The most common explanation is that there is a lag in the adjustment of consumption to higher levels of disposable income. Saving decisions are thought to be based on consumers' perceptions of their "permanent income," which they systematically underestimate under conditions of rapid growth. This hypothesis, however, seems implausible, given the high saving rate during the deceleration of income growth in the late 1970s. Theories that attribute the high saving rate to the slowness of consumption to adjust to income changes treat saving as passively determined. Given the important motives for saving, it may be that saving takes priority in household decisions and consumption is determined as a residual.

According to the explanation of consumer behavior developed by the Nobel laureate economist Franco Modigliani, demographic factors have a major impact on saving rates. The life-cycle theory postulates that people save in their middle years to repay debt and provide for retirement, and dissave in their later years. The assumption that income is relatively low at the beginning and end of a person's life and high during the middle correctly describes Japan's seniority wage system, under which workers enjoy a steady increase in wages until they retire at the age of 55 or 60, and then experience a sharp drop in income. The life-cycle theory also assumes that individuals prefer a stable or slightly increasing level of consumption, leading them to save during their high-income years to support consumption later on.

Japanese statistics showing households headed by persons 60 and above with high saving rates appear to contradict the life-cycle theory, but this result is due to other factors, such as a smaller than average number of household members and a greater than average number of earners, both of which tend to increase saving. Tuvia Blumenthal, in Savings in Postwar Japan, showed that the effect of age, holding other factors constant, is to increase saving up to age 45 and to decrease it past age 55.

Because Japan's postwar population growth has been slow relative to prewar years, there are relatively few children and older persons compared to the number of working-age people (see Table 5). The ratio of children and older persons to the working-age population fell steadily from 1950 to 1970, a decline that raised the saving rate. Since 1970, the ratio has risen modestly, helping to explain the small decline in household saving since the first oil shock.

Table 5: Demographic Change in Japan

(population in millions)

	Young (1-14)	Productive Age (15-64)	Aged (over 65)	Dependency Ratio*
1930	23.6	37.8	3.1	70.5
1940	26.4	43.3	3.5	69.0
1950	29.4	49.7	4.1	67.5
1955	29.8	54.7	4.7	63.1
1960	28.1	60.0	5.3	55.7
1965	25.2	66.9	6.2	46.8
1970	24.8	71.6	7.3	44.9
1975	27.2	75.8	8.9	47.6
1980	27.5	78.8	10.6	48.4
1981	27.6	79.3	11.0	48.7
1982	27.3	80.1	11.3	48.2
1983	26.9	80.9	11.7	47.7

*The dependency ratio equals the sum of the young and the aged divided by the productive age population.

Source: Management and Coordination Bureau, Japan Statistical Yearbook 1984

The nation's demographic transition is reflected in the declining size of the average household. Blumenthal's research suggested a significant inverse relationship between a household's rate of saving and the number of members. The average household fell sharply from 4.97 persons in 1950 to 3.69 in 1970 and 3.33 in 1980. While a larger number of children encourages saving for education and marriage, it also increases consumption.

In addition to the low birth rate, the trend toward nuclear families has lowered the average household size. According to Japanese custom, the first son is obliged to support his parents in their old age and he expects to be supported in turn by his children. The percentage of families living without parents, however, rose from 63 percent in 1960 to 71 percent in 1970 and 75 percent in 1980. This increase has encouraged saving since more people must depend on their own resources rather than on their children's. It is not surprising that the generation now reaching retirement age is frugal, since this group generally fulfilled the obligation to support one's parents but cannot expect to be supported by its children. The increase in the proportion of nuclear families has also been a result of the migration from farming, where families traditionally consisted of three generations. The proportion of the labor force engaged in agriculture and forestry fell from almost one-half in 1950 to 16 percent in 1970 and 10 percent in 1980.

The life-cycle theory postulates that the expected duration of an individual's retirement and the level of consumption planned determine his level of saving. Thus, the increase in life expectancy has encouraged workers to save more to provide for a longer retirement. Life expectancy in Japan in 1947 was only 50 years for men and 54 years for women; by 1983, it had increased to 74.5 years for men and 80.2 years for women, the highest in the world. The depreciation of financial assets caused by inflation in the 1970s also encouraged saving. Households had to increase their saving rate to maintain the desired real standard of living in retirement.

In the past, Japan's high saving rate was attributed to the absence of social security. Given the importance of retirement as a motive for saving, it was expected that the development of a social security system in Japan would reduce the saving rate. Japan's household saving rate remains high, however, despite the establishment of the Employees' Pension Insurance system, which pays liberal benefits, roughly comparable to this country's. The system pays the equivalent of about 60 percent of a worker's salary, commencing at age 60 for men and 55 for women. With about 10 workers paying into the pension fund for every recipient, the system is accumulating substantial reserves.

Given the many economic, demographic and cultural changes in Japan during the past 30 years, it is difficult to isolate the effect of the social security system on the rate of saving. It is unlikely, though, to have had a major impact for several reasons. Many of the lifetime employment jobs at major companies still end at the age of 55, forcing workers to save for the five-year period prior to their pension eligibility. Moreover, given the rapid aging of Japan's population, many question the viability of the present system. The share of the population 65 and over is expected to reach 16 percent by the year 2000 and climb to 22 percent -- the highest in the world -- in 2020. Two government economists have estimated that the pension fund will be exhausted by the year 2008. To maintain the current level of benefits, contributions (shared equally by employer and employee) will have to rise to 40 percent of income.

The demographic factors that have increased the level of saving in Japan have reduced it in the United States. Because of this country's postwar baby boom, there are a large number of consumers in the prime borrowing age group (aged 25 to 45) relative to the number in the prime saving group (aged 45 to 65). The U.S. saving rate peaked at just over 8 percent in the early 1970s when the ratio of prime savers to prime borrowers was highest.

Why Is Japan's Saving Rate Higher Than the United States'?

Including spending on consumer durables, which some economists consider a form of saving, in household saving, reduces the difference between the two countries' saving rates. From 1970 to 1981, for example, U.S. households devoted 2.5 times as much of their income to consumer durables as Japanese households. But no matter how consumer durables are treated, the fact remains that Japan's household saving rate is much higher than this country's.

Nearly every Japanese characteristic that differs from other countries has been offered as an explanation of this phenomenon. According to government surveys, the major motives for saving money are unexpected disaster, children's education and marriage, provision for old age and housing. Saving by households for the above reasons, however, does not necessarily imply that the saving rate for the household sector as a whole will be higher. Strong saving motives imply equally strong dissaving when households spend for the intended purpose.

Government surveys show that families have higher saving rates before their children enter high school and sharply lower and sometimes negative rates while their children are in high school and college. Charles Horioka, in Household Saving in Japan: The Importance of Target Saving for Education and Housing, showed that aggregate saving for education has been positive in the postwar years due to population growth, rising education costs and an increase in the college entrance rate. But he estimated that saving for education accounts for less than 4 percent of total household saving and that its importance has been declining for the past 10 years.

The purchase of a home is an important motive for saving. Government surveys indicate that the sooner a household intends to purchase a home, the higher its saving rate and that families owning homes save a smaller share of income. Prof. Horioka estimated that aggregate housing-related saving accounts for 41 percent of total household saving, although saving for this purpose cannot explain trends in the rate of saving over time. In a separate study, Bank of Japan economist Kazuhiko Nagato estimated that greater Japanese saving for housing accounted for about 40 percent of the saving rate differential between Japan and the United States.

For a number of reasons -- a mass migration to the cities, an increase in the number of households as a result of population growth, and the trend toward nuclear families, there was a shortage of housing following the war. The inadequacy of much of the existing housing stock produced a strong demand for new housing as real income rose. Moreover, the rapid rise in land and housing prices greatly increased the amount of money required to purchase a home.

The price of housing obviously reflects the high population density of Japan, which is about 13 times greater than that of the United States. Although Japan is only 4 percent as large as this country, the total value of land in the two countries is nearly equal. The government's land taxation, zoning and construction policies further constrain the supply of housing. For example, low real estate taxes on farmland keep valuable tracts in agricultural use, aggravating the shortage of real estate for housing. Almost 15 percent of the land in Japan is used for agricultural purposes, compared to the 3.8 percent that is in residential use.

Reflecting the high price of land, the average Japanese home in 1983 cost 7.9 times average annual income. Down payments, which must be large to make the monthly loan repayments affordable, are equal to about three times average annual income. Moreover, interest payments on home mortgages are not tax deductible. All of this gives young families a great incentive to save for a down payment. As a result, the median age of a first-time home buyer in Japan is 40 years, compared to 30 years in the United States.

Japan's higher saving rate cannot be attributed to a lower tax burden. According to the OECD, Japan's total tax burden at the end of 1983 stood at 28 percent of GDP, only one percentage point less than the U.S. figure. But the tax system does have an important effect on saving behavior: in Japan it is structured to encourage saving, while in the United States it promotes consumption. Interest on savings accounts of up to Y14 million ($70,000 at current exchange rates) is tax-exempt in Japan, and capital gains taxes are also low. On the other hand, consumer loans are scarce as well as expensive, and interest payments are not tax deductible. Consumer loans other than home mortgages account for only 1 percent of total bank lending. In the United States, by contrast, interest earned on savings accounts is taxable, while interest paid on loans is deductible. For taxpayers in the 50 percent bracket, a loan carrying an interest rate of 10 percent has an after-tax cost of 5 percent.

Government regulations in Japan have kept interest rates on saving deposits low, which has two opposing effects on the rate of saving. First, it discourages saving by raising the price of future income. But perhaps more importantly, it has made consumers save more to meet their personal goals.

There are many more cultural and institutional factors that have been suggested as explanations for Japan's saving behavior. One of the most convincing is that the years of deprivation during the war made the Japanese more willing to save for the future. Another is that the longer work week in Japan limits recreation and discourages consumption of leisure-related goods. The average Japanese works 42.5 hours a week compared with the U.S. worker's 37.5-hour week.

Conclusion and Outlook

The rise in Japan's household saving rate resulted primarily from demographic changes and efforts of families to rebuild their financial assets following World War II. Due to rapid population changes prior to the war and slow growth following it, the share of working-age people increased until the 1970s while the proportion of children and older dependents fell. Demographic factors also help explain why Japan's saving rate remains at a high level while U.S. saving is at all-time low levels. Other factors contributing to the higher level of saving in Japan are the high cost of housing and a tax system biased in favor of saving rather than consumption as in the United States.

Many economists in both the government and the private sector expect Japan's household saving rate to fall by two to four percentage points during the next 10 to 15 years. According to the life-cycle theory, the aging of Japan's population should lower the saving rate. Furthermore, saving for housing may become less important. The number of available housing units topped the number of households in 1984 for the first time since 1968, and the percentage of owned-occupied houses reached 62.3 percent in 1983 compared to 59.2 percent 10 years earlier.

Since saving behavior is affected by social and cultural changes as well as economic forces, it is difficult to predict the future level of saving. But it is unlikely that changes either in government policy or economic factors will quickly alter Japanese saving habits. Household saving will remain at high levels as long as families continue to feel a strong need for saving.

Japan's high saving rate, therefore, is likely to continue to contribute to its huge trade surplus and to conflicts with its trading partners. It is important for Tokyo to encourage and promote domestic investment in order to absorb surplus saving. Japan's trading partners should also realize that Japan's high saving rate performs an important function by helping to meet capital shortages abroad. In a capital-scarce world, Japan's high level of saving is a valuable resource that should be used to promote economic growth in less-developed countries, as U.S. capital was used to finance reconstruction in Europe following World War II.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

Appendix: The Calculation of the U.S. Saving Rate

Gross saving is defined as total income less private and government consumption, while net saving is equal to gross saving less depreciation. Saving can be measured as the difference between total income and current outlays or as the increase in assets less the increase in liabilities. The Federal Reserve Board's Flow of Funds (FOF) measure uses the latter approach while the Department of Commerce's Bureau of Economic Analysis uses the former approach to estimate saving in the National Income and Product Accounts (NIPA). There are major differences in the two measures of saving. In 1983, for example, personal saving as estimated by the FOF was $274.5 billion, or 11.8 percent of disposable income, but according to the NIPA measure, it was only $113.6 billion, or 4.9 percent of disposable income.

Conceptual differences account for about two-thirds of the disparity in the saving estimates. The major difference concerns the treatment of consumer durables, such as cars, furniture and appliances. In the NIPA, all consumer spending is treated as consumption; the FOF classifies purchases of consumer durables as saving. A further difference is the classification of government life insurance and retirement funds, which affects the distribution of saving between the public and private sectors.

Statistical discrepancy, which accounts for much of the difference in the two measures, reflects the fact that each measure calculates saving as a residual. Any error in the underlying series, therefore, affects the estimate. The sizable statistical discrepancy in the international balance of payments between the balances in the current account and the capital account is responsible for part of the difference in the two measures of saving. Net foreign investment is equivalent to net flows of foreign and domestic assets in the FOF measure and to the current account balance in the NIPA. The discepancy between NIPA and FOF, therefore, could result from an underestimate of net exports (making the NIPA estimate too low) or an underestimate of capital inflows (making the FOF estimate too high). The fact that most economists believe that the capital account is the likely source of the statistical discrepancy in the balance of payments suggests that the NIFA measure is preferable.

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U.S.-JAPAN TECHNOLOGY FLOWS: A TWO-WAY STREET?

Summary

In the eyes of many Americans, Japan is in the forefront of the current foreign challenge to U.S. technological leadership. Japanese and foreigners alike realize that this would not have been possible without significant imports of technology. Japan has drunk most deeply of all foreign countries from the fount of U.S. technology, perhaps increasing American concern over the Japanese challenge. Although the balance remains tipped in favor of technology imports, exports of Japanese technology have experienced rapid growth in the past few years, benefiting the United States, which absorbs the largest share. Despite this more even exchange, many Americans feel that the United States is not taking full advantage of Japanese technological developments. This report will review the history of U.S.-Japan technology flows and examine current efforts to develop a true two-way street.

Borrowing: A Japanese Tradition

Borrowing from abroad has been a constant theme in Japan's history. Early on, the Chinese writing system was adopted and adapted to the indigenous spoken language, just as Chinese civil administration became the model for Japan's feudal bureaucracy. Even in situations where Japan had developed its own technology, in metallurgy and ceramics for example, the borrowing and tailoring of foreign know-how was freely practiced.

Although Japan was ostensibly closed to foreign influence during the more than 200 years of the Tokugawa period, nearly half of all Japanese males during this interlude received some sort of education, a development with important consequences for economic growth. By the close of the Tokugawa Shogunate in 1868, Japan's literacy rate rivaled those of the countries of Europe and the United States. Therefore, although isolation had frozen the existing level of technology at a low point in comparison to the West, Japan had the potential to close the gap rapidly.

This latent quality was fully expressed during the Meiji modernization drive. Foreign experts were hired to build railroads, shipyards, steel and textile mills. There were many false starts and failures among the multitude of attempts to borrow Western technology, but more importantly, Japan developed an awareness that it must not only actively control the inflow of technology, making the best or most appropriate choices, but it must also actively seek out these technologies from abroad. To this end, the Japanese government and the private sector began to construct an information-gathering network of global proportions.

Economic intelligence-gathering has always been practiced by embassy personnel abroad, but Tokyo's efforts were unusual because there was a direct link to commercial activities. Japanese firms could keep abreast of foreign developments through government sources and were often encouraged by Tokyo to adopt foreign technology. Many of the companies that introduced Western technology were at least partly funded or sponsored by the government.

These efforts paid off handsomely. By the turn of the century, Japan was able to abandon the "unequal treaties" it accepted during the early 1870s, and in 1905 it defeated Russia in combat for the rich resources of Manchuria -- ample evidence that Japan had developed an economic base sufficient to support a modern army and modern political institutions.

The borrowing continued apace throughout the years before World War II. A significant number of students were sent abroad for technical training and higher education. And although Japanese companies became more confident about striking technology deals, the government remained the driving force behind rapid technological change through 1945.

Technology Imports: Raw Fuel for Japanese Growth

The devastating effects of the Pacific war pushed Japan back to square one in terms of technology. The components for rapid growth, however, were again abundant. By the time Japan was able to satisfy its basic needs, the United States had forged ahead, creating a gap that made borrowed technology highly profitable for domestic firms. In addition, the education system was redrawn along Western lines thanks to the American occupation. Finally, Tokyo again played a key role in the technology transfer process, but this time through regulatory rather than direct means.

The results were, if anything, more impressive than the earlier effort. The inflow of technology in the form of licensing and joint venture agreements skyrocketed, according to Ministry of Finance data (see Tables 1 and 2). Under the new Ministry of International Trade and Industry, the technology selection

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Table 1: Japan's Technology Imports, FY 1950-FY 1983

(number of approved cases and value in billions of yen)

	Cases		Value	
	Total	Of Which New:	Total	Of Which New:
FY 1950-55	1,148	n.a.	Y24.9	n.a.
FY 1960	588	n.a.	34.2	n.a.
FY 1965	958	n.a.	60.1	n.a.
FY 1970	1,768	n.a.	155.9	n.a.
FY 1975	6,766	796	169.1	Y13.3
FY 1976	6,050	632	177.3	17.9
FY 1977	6,659	685	190.1	16.9
FY 1978	6,573	936	192.1	38.2
FY 1979	7,012	1,020	241.0	26.8
FY 1980	7,248	919	239.5	27.7
FY 1981	7,207	844	259.6	24.9
FY 1982	6,936	929	282.6	44.4
FY 1983	7,839	1,073	279.3	42.4

Table 2: Japan's Technology Exports, FY 1950-FY 1983

(number of approved cases and value in billions of yen)

	Cases		Value	
	Total	Of Which New:	Total	Of Which New:
FY 1950-55	n.a.	n.a.	Y0.3	n.a.
FY 1960	n.a.	n.a.	0.8	n.a.
FY 1965	n.a.	n.a.	6.1	n.a.
FY 1970	861	n.a.	21.2	n.a.
FY 1975	2,811	1,073	66.6	Y18.9
FY 1976	2,767	775	83.4	27.0
FY 1977	2,880	897	93.3	36.3
FY 1978	3,157	1,063	122.0	47.1
FY 1979	3,667	1,087	133.1	52.1
FY 1980	4,103	1,137	159.6	74.3
FY 1981	4,877	2,017	175.1	70.8
FY 1982	4,738	1,970	184.9	63.3
FY 1983	6,403	2,494	240.9	74.9

Source: Prime Minister's Office, Report on the Survey of Research and Development process became even more discriminating. Through a succession of economic outlooks called "industrial visions," MITI encouraged certain sectors and discouraged others. MITI was not omnipotent, nor were all its efforts successful, but the Japanese economy did gain access to key basic technologies that placed it in a good position to take advantage of the boom in international trade in the 1960s, the electronics revolution of the next decade and the current information explosion.

Most of the transfer agreements were voluntarily accepted by foreign firms, particularly American, because the Japanese did not seek state-of-the-art technology. Indeed, not only was older technology cheaper, but it was also more supportable in terms of the skilled labor and infrastructure required. Even this "hand-me-down" technology offered improved efficiencies compared to what was available after the war, translating into continued demand for foreign know-how.

As reconstruction advanced, however, Japan began to seek technology that was central to the emerging U.S. electronics industry. Particularly in the case of International Business Machines Corp., Tokyo conditioned the manufacture of advanced IBM products on the licensing of basic patents that would allow Japanese firms to develop IBM-compatible equipment. In other cases, the Ministries of International Trade and Industry and Finance cooperated by barring foreign companies from establishing wholly owned subsidiaries and arranging joint venture partnerships instead. Foreign firms were faced with being shut out of the Japanese market or gaining a presence in exchange for the transfer of technology. Many chose to accept the joint venture route, in part because it was usually of limited duration; the two partners were free to go their own way once the agreement expired. Surprisingly, MITI often had trouble winning the cooperation of the Japanese company, which was no more enamored of the forced marriage than the foreign firm. The joint venture between Texas Instruments Inc. and Sony Corp. is a good example -- MITI proposed the partnership when TI sought a foothold in Japan and controlled important patents (see Council Report No. 9, March 7, 1980).

These arranged partnerships became less and less frequent as Japanese firms built up a critical mass of research and development work. There was also a gradual shift of attitude toward less government interference in technology licensing because of this development, particularly after 1980. The levers used by MITI and MOF were also substantially weakened by the beginning of this decade, although the two still retain residual controls on technology flows.

How MITI and MOF Did It

An unusual set of circumstances combined to give MITI and MOF their very strong control over the flow of technology. The extensive war damage previously mentioned had one overriding consequence: it magnified the basic economic problem of how to meet a variety of needs with very limited resources. To meet this need, Tokyo intervened with extensive economic and financial controls. This position was accepted by a population that faced starvation and very high unemployment in the immediate postwar years.

In one sense, the government's task was easy -- almost any imported technology would yield a satisfactory return. On the other hand, it was difficult to balance the needs of reconstruction with the imperative of defending the value of the yen under the Bretton Woods fixed exchange rate system. Tokyo was forced to put on the fiscal and monetary brakes when the overheated economy threatened several times to depress the value of the yen, inducing "recessions."

In addition, the task was complicated by disagreements between the government and private companies over what sectors should be developed. Government planners were no more prescient, and in some cases less so, than company presidents at picking winners and losers. The support they gave to shipbuilding, textiles and aluminum while at the same time discouraging the automotive and audio industries is an example of MITI's misjudgment. On the other hand, MITI did give the electronics and computer industries a boost.

In any case, the extreme demands on Japan's foreign exchange reserves during the reconstruction process led to the Foreign Exchange and Foreign Trade Control Law (Public Law No. 228), enacted December 1, 1949, and the companion Law Concerning Foreign Investment (Public Law No. 163) of May 10, 1950. By virtue of the fact that technology licenses have to be bought, and foreign investors often wish to repatriate profits, these two laws gave MOF and MITI the power to regulate most forms of technology transfers.

Foreign Exchange and Foreign Trade Control Law - In order to conserve the nation's scarce foreign reserves, MOF developed a set of rules covering financial flows into and out of the country. Controls on inward flows were meant to prevent private companies from over-commiting themselves, but also to insure that only "proper" transactions were made. Although the law itself did not explicitly mention technology licensing agreements, it covered all foreign transactions, including services trade (Article 27). To wit, Article 42 stated, "Unless authorized as provided for by Cabinet Order, no person shall contract for services involving payment, settlement or any other transaction governed by the provisions of this law." Pursuant to this, Article 17 of the Cabinet Order Concerning the Control of Foreign Exchange (No. 203, June 27, 1950) was amended in 1963 to require residents and non-residents to obtain a license for services contracts, including those covering "technological assistance."

The implementing ministerial ordinance (No. 50 of 1950) was not wholly satisfactory because it was too vague for all parties concerned. Private companies were not sure how to structure proposals to meet MOF requirments, nor were MOF personnel sure of the impact of particular contract provisions. Foreigners were certainly mystified by the process and unhappy with the strict exchange control requirements.

Because of these problems, two new ordinances were issued: Concerning Control of Invisible Trade Transactions Relating to Foreign Trade (MITI Ordinance No. 49, April 1, 1963); and Concerning Control of Invisible Trade Transactions (MOF Ordinance No. 58, November 2, 1963). The first provided a relatively simple form for the technology importer, and the latter established clearer guidelines as to what kind of MOF approval was needed under the circumstances. The Finance Ministry order also established a list of "designated" technologies considered particularly desirable that would be handled expeditiously. At that time, this list covered technologies dealing with nuclear energy, aircraft, space development, computers and petrochemicals.

Although these laws would seem to be adequately comprehensive, MOF felt early on that inward foreign direct investment represented a special case. Therefore, a subsidiary law was drawn up that included even more specific regulations to promote and regulate technology flows.

Law Concerning Foreign Investment - Technological assistance, according to the law, covered the transfer of patents or utility model rights or technologies and license agreements thereof; technical assistance in factory management; and technical assistance concerning the management of enterprises or workshops in a wide range of industries. Until 1964 the provisions of this law came into effect when the payment period stipulated in the contract was one year or more (A-class contracts). Contracts for payment in less than one year (B-class contracts) were governed by the Foreign Exchange Control Law. Many foreign firms preferred the longer period because the foreign investment law had more lenient repatriation provisions. This distinction was eliminated in 1964 when Japan adopted Article 8 of the International Monetary Fund guidelines. Subsequently, all technological assistance contracts have been governed by the foreign investment law (except in cases where no desire to remit payment exists, in which case no regulations are applicable).

In brief, the law required that all technology transfers be validated by the Minister of Finance and any other appropriate minister (Articles 7, 8 and 10). The guidelines for approval were quite broad. Contracts that improved the nation's balance of payments, developed essential industries, or were essential for the continuation of earlier contracts were to be approved. On the other hand, if the contracts were "unfair," illegal, could have an adverse effect on the rehabilitation of the Japanese economy, or negatively affect Japan's foreign exchange situation, they could be denied. MOF and other ministries clearly had a great deal of latitude in screening technology agreements. While the law stipulated that the appropriate ministries had to respond within 30 days after receiving a request for validation, it was possible to ask for an extension. The ministries were not required to explain why a request was or was not approved. There was an appeal process, but it did not assure transparency or objectivity.

Both the foreign exchange control law and the foreign investment law contained reporting requirements for residents and non-residents alike. MOF had to be notified of a technology transfer deal before a validation request was submitted and after it had been consummated. Any alterations or renewals were also to be logged with the ministry. In an effort to ease this requirement, MOF and MITI permitted the Bank of Japan to act as their agent for many clerical tasks. The process remained relatively complicated and mysterious, however.

The application of the regulations varied in severity over the years. On occasion, the atmosphere was relatively open. At other times, ministries were openly hostile to certain types of contracts. This uncertainty sometimes played into the hands of Japanese companies -- just the threat of government interference was enough to push some foreign firms into joint ventures or licensing contracts.

Upon joining the Organization for Economic Cooperation and Development in 1964, Japan was obliged to liberalize controls on capital flows. Tokyo's pace of liberalization was slow but steady, and by 1976 foreign direct investment in all but four industries would, in theory, receive automatic approval. Although this also applied to technology assistance contracts, MITI maintained a close watch on the flow of know-how.

The Present Regulatory Situation

When full compliance with the OECD's guidelines on capital transactions was achieved in 1980, MOF supposedly lost its powerful foreign exchange controls and MITI eased the foreign direct investment regulations. Although the levers still exist on paper, they are only supposed to be used under extraordinary circumstances.

A November 20, 1980 ordinance originating from every ministry, including the Prime Minister's Office, effected these major changes. It should be made clear that the framework for technology transfers has not changed -- the reporting and validation requirements are still in effect, mainly for data collection purposes. What has changed is the speed with which ministries must approve requests (one day to two weeks, depending on the number of ministries involved and the type of application) and the controls on payments, which have been eliminated. In support of this umbrella ordinance, MITI and MOF have also issued separate regulations to amend earlier directives as necessary.

Going even further, the government announced in June 1985 that practically all foreign direct investment applications, including technology-related contracts, will be immediately approved. The ministries involved in an application can ask for a short period of time to consider important contracts, but this should be an infrequent occurrence.

Patents and Other Forms of Transfers

The purpose of patents and utility models (actual working models embodying patentable inventions) is two-fold: to protect the interests of the inventor while allowing others to study and learn from the invention. Japan's patent system was modeled after this country's, and remains in essentially its original form today. The spirit of the Japanese patent process, however, is somewhat different than what the American occupation may have intended. As is generally the case in Asia, the Japanese have a very different view of industrial intellectual property. Although it is somewhat of an exaggeration, copying is still considered a form of flattery. Protections for industrial intellectual property have been traditionally weak in Japan, despite its participation in the Paris Convention on Industrial Property and the World Intellectual Property Organization.

Surprisingly, Japanese companies have developed the practice of patenting everything they can -- a reflection of intensely competitive home markets. In fact, they have extended this practice abroad. Tables 3 and 4 present data from the Japanese and U.S. patent offices on the overall number of patents granted, as well as the number granted to the other's nationals. It is obvious that there is a great deal of technology transfer taking place via patents -- activity that is rapidly accelerating.

Government-sponsored exchanges of researchers and joint research projects are a small but not insignificant conduit for technology exchange.

Until recently, it is safe to say that Japan and other countries got the most benefit from such exchanges. As evidenced by a number of Defense Department trips and public conferences in Japan, however, Tokyo now has a number of interesting technologies to offer.

Table 3: U.S. Patents Applied For and Granted, 1978-83

(cases)

	Applications		Granted	
	Total	By Japan	Total	To Japan
1978	109,300	10,400	70,500	7,100
1979	106,900	11,100	52,400	5,800
1980	113,000	13,100	66,200	6,600
1981	114,500	14,400	71,000	8,500
1982	118,400	17,300	63,300	8,800
1983	112,400	15,700	62,000	8,600

Source: U.S. Patent Office

Table 4: Japanese Patents Applied For and Granted, FY 1978-FY 1983

(cases)

	Applications		Granted	
	Total	By the U.S.	Total	To the U.S.
FY 1978	166,100	10,300	45,500	4,000
FY 1979	174,600	9,900	44,100	4,600
FY 1980	191,000	10,400	46,100	4,000
FY 1981	218,300	12,000	50,900	4,500
FY 1982	237,500	14,200	50,600	4,100
FY 1983	255,000	16,000	54,700	4,200

Source: Japanese Patent Agency

Commercial efforts to obtain foreign technology have grown in sophistication and variety. While efforts once were limited to intelligence gathering, licensing negotiation, and perhaps assigning personnel to study abroad, companies now invest directly in firms with promising technologies, sponsor research at foreign institutions and establish research centers staffed by foreign and domestic scientists.

Perceptions of Problems

As Japan and the United States find themselves locked in technological combat across a wider and wider range of industries, dissatisfaction with each other's attempts to control technology flows has developed. For Japan, the biggest obstacle is the Reagan administration's national security fixation. Trying to insure that U.S. technology does not benefit our enemies has always been a concern, but only since 1980 has the Defense Department been able to implement tighter controls. Japan has often felt itself the target of DOD's censorship, although this is unlikely. By closing scientific conferences to foreigners, the Pentagon seems to be intent on keeping information out of the hands of allies and enemies alike.

Unfortunately, the U.S. list of complaints is much longer than Japan's.

- Residual regulatory controls have been the focus of U.S. attacks for some time. The argument is made that even simple reporting requirements act as nontariff barriers.

- The Japanese patent process also comes in for some licks. The fact that it can take a number of years for a patent to be approved, during which time competitors can examine and learn from the application, has been a major disincentive to foreign firms seeking to introduce their latest technology in Japan.

- In stark contrast to the U.S. scientific community, there is a profound lack of scientific publishing in Japan. Much of the research done within private firms is never disseminated or discussed. Not only does this lead to duplication of effort among Japanese companies, but it produces a less open situation than Japanese companies enjoy abroad.

- While Japanese firms can freely sponsor research at U.S. universities and research institutes, the same is not true in Japan. Indeed, it is even difficult for Japanese firms to fund research at a Japanese university. The blame must rest equally on government regulations covering such activities and on the closed nature of Japan's universities.

- Again, in contrast to this country, foreign firms have difficulty investing in Japanese companies that have promising technologies. Over the past several years Japanese companies have set up offices in American high technology havens, such as California's Silicon Valley and Massachusetts' Route 128 corridor, both to collect information and locate attractive investment opportunities. The barriers to such activities in Japan are institutional and cultural. Investment information sources are not well developed in Japan, reflecting the difficulties of arranging friendly participation in Japanese companies.

- National defense concerns also hinder U.S. access to Japanese technology, but in a rather upside-down way. Because of provisions in Japan's constitution banning offensive weapons, or aid to countries engaged in combat, MITI proscribes the export of particular military technologies. The Pentagon obviously finds this irksome.

Efforts to Improve the Two-Way Street

It is clear that some of these problems are more tractable than others. In light of the increased potential for trade frictions in the high technology area, moves to enhance the exchange of technology are afoot in both the public and private sectors on both sides of the Pacific.

- U.S. participation in Japanese government research projects - Tokyo's financial support for the development of industrial technologies has generated repeated complaints from U.S. government and industry circles. A major source of criticism is that the Japanese subsidiaries of Amercian companies are not eligible to participate in these projects, which some observers believe are the key to the international competitiveness of Japan's semiconductor and computer industries. This issue is one of the points raised by the Reagan administration during this year's intensive bilateral negotiations on electronics trade.

MITI representatives maintain that any company, foreign or domestic, can apply for government-funded R&D contracts. As proof, they cite the participation of several foreign firms in the Sigma project, a new five-year, Y25 billion ($122 million at Y205=$1.00) government-backed effort to develop an automated software production system. Moreover, DIC-Degremont Ltd., a partnership between France's Societe Lyon des Eaux and Dainippon Ink & Chemicals Inc., will join the Aquarenaissance 1990 project. This five-year program aims at developing a sewage treatment facility using bioreactors and ceramic filters that can turn sewage into drinking water and organic fuels such as methane.

Observers are still not convinced of MITI's commitment to foreign participation, however, citing strong pressure from the European Community and France to accept DIC-Degremont. To date, no American companies have won entry into a cutting-edge R&D program -- the Japanese cite a lack of U.S. interest, while Americans fault a dearth of Japanese information about upcoming projects. Nevertheless, the potential for significant cooperation is there.

- U.S. access to Japanese government patents - A related issue is foreign access to patents partly or wholly controlled by the Japanese government. MITI's Agency for Industrial Science and Technology, which has a say in licensing the patents that result from government-sponsored projects, has been reluctant to strike deals with interested foreign firms. IBM, however, recently gained the opportunity to inspect and license government-owned patents (see JEI Report No. 32B, August 23, 1985). This is a potentially important breakthrough, since it gives IBM access to ongoing and future AIST programs. It is unclear, however, if other companies will be granted similar privileges.

- Patent information via database - Patent offices in Japan, the United States and Europe are taking the first steps toward creating a single database covering patent applications. Although it is not envisioned that the various nations will unify their patent authorities, such a database will make cross-checking and international filing much more efficient.

- Congressional initiatives - The Hill has hopped on the bandwagon by passing a bill improving the information-gathering ability of the Commerce Department's National Technical Information Service. NTIS's mission is to evaluate not only domestic technologies but foreign ones as well. On November 23 the Senate approved an amendment to the Stevenson-Wydler Technology

Innovation Act of 1980 (S 1073) "for the purpose of improving the availability of Japanese science and engineering literature in the United States" (see JEI Report No. 46B, December 6, 1985). In previous hearings, NTIS officials had pointed out that their limited resources prevent them from translating more than a handful of technical treatises every year. If the Senate bill passes the House, it could give NTIS's efforts a big boost.

- Japanese publishing ventures and information services - In a parallel development, an information revolution of a different kind is taking place in Japan. Small companies that specialize in finding and translating Japanese technical and patent information are appearing with increasing frequency. In addition, many major Japanese newspapers and industry journals are beginning to offer foreign-language summaries of patents and research results. While the price may be high and the information of questionable veracity, it is still a big improvement over the void that existed in the past.

- Commercial efforts - Despite the daunting problems of penetrating Japan's research circles, American industry associations and individual companies persist in their efforts. Both the Electronic Industries Association and the American Electronics Association have information centers in Japan. Companies that cannot afford an outpost on their own are combining resources with other firms to establish a presence in Japan. Finally, major companies are founding research centers in Japan, hoping to attract input from academia as well as other businesses.

Additional steps are planned or contemplated to improve the bilateral situation. Japan's patent office is trying to automate its procedures to significantly reduce the processing time. Patent office officials discussing procedural reforms have also invited American and European businessmen to voice their opinions on how to simplify the process; these views will be incorporated in a report due out in July 1986. Moreover, DOD has been receiving so much flak from the American scientific community over its attempts to restrict the dissemination of information that greater discretion may be employed.

Conclusion

Japan has clearly benefited from its efforts to collect and adopt foreign technology. Characteristics such as a tradition of borrowing, a mentality devoted to "catching up" with foreigners, a highly educated population and strong government policies certainly have aided the assimilation of foreign know-how. Although other countries may not be able to duplicate all these factors, the key lesson is to avoid the "not-invented-here" syndrome -- the arrogant opinion that foreign technology is always inferior to what is available at home.

Japan's balance of technology trade has moved closer and closer to parity, due not only to transfers to industrial nations but also to a wide range of developing countries. In spite of this trend, the flow of U.S. technology to Japan will almost certainly remain greater than the reverse. Japan is clearly at the frontier of technology in several areas, yet because the infrastructure to promote the transfer of that technology to the United States remains underdeveloped, U.S. efforts are likely to be handicapped for some time.

Since this means that any rough spots will take years to smooth out, the United States and Japan will probably continue to experience problems. Despite the explosive nature of these problems, the potential for a major conflict over technology transfer is small. Both sides would rather prove that they can outrun the other in the technology race than try to hamper the other's progress. Joint public research projects, cooperative commercial R&D efforts and a freer exchange of research personnel will all help to dispel nagging fears.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

JEI Report will not be published on December 27 or January 3 because of the Christmas and New Year's holidays. The next issue will appear January 10, 1986.

Appendix

Table 1: Japan's Corporate Technology Trade by Industry, FY 1980-FY 1983

(number of cases and value in millions yen)

a. FY 1980

	Exports				Imports			
	Total		New		Total		New	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Total	[illegible]	[illegible]	1,227	Y74,263	7,248	Y239,529	919	Y27,675
Agriculture	7	327	2	*	40	0	2,472	0
Mining	10	887	3	43	32	669	8	204
Construction	215	25,599	85	14,374	203	2,707	34	1,330
Manufacturing	[illegible]	155,274	1,140	49,798	6,939	233,185	857	25,773
Food Products	68	2,169	18	80	90	9,642	18	687
Textiles	81	8,159	17	259	161	2,253	28	170
Pulp and Paper	25	567	[illegible]	16	135	1,410	13	62
Publishing and Printing	12	196	1	*	47	968	3	*
Chemicals	657	31,879	201	9,767	840	39,252	120	3,403
Textiles	388	25,537	132	9,155	461	16,656	57	2,377
Fertilizers	140	1,097	28	181	120	2,951	9	210
Pharmaceuticals	168	2,688	25	275	132	10,162	26	600
Other	81	2,548	17	152	127	9,483	28	426
Petroleum	13	1,867	4	*	110	9,678	29	8,034
Rubber	56	1,226	[illegible]	47	128	5,942	8	53
Glass	[illegible]	7,084	54	[illegible]	152	9,612	25	921
Iron and Steel	125	27,874	109	8,428	295	8,025	47	1,997
Nonferrous Metals	173	5,083	45	1,217	200	3,690	19	276
Metal Manufactures	77	1,122	18	118	225	4,440	15	108
Nonelectric Machinery	455	9,603	236	4,285	1,481	30,359	118	1,980
Electric Machinery	781	27,015	134	3,440	1,311	81,656	254	4,959
Machine Tools	368	7,807	45	559	390	21,778	46	1,532
Electronics	413	19,278	109	2,881	1,121	59,899	208	3,427
Transportation Equipment	590	21,758	88	11,819	941	40,274	87	1,832
Automotive	284	8,432	21	701	258	10,365	40	540
Other	306	13,326	67	11,118	685	29,908	47	1,291
Precision Machinery	38	873	14	182	256	4,448	27	269
Other	480	8,175	153	1,753	238	3,187	46	1,020
Transportation, communications	15	124	7	116	154	495	20	368

b. FY 1981

	Exports				Imports			
	Total		New		Total		New	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Total	[illegible]	[illegible]	[illegible]	[illegible]	7,097	Y259,632	844	Y24,911
Agriculture	11	414	8	[illegible]	3	*	1	*
Mining	18	451	[illegible]	[illegible]	51	661	4	*
Construction	274	[illegible]	24	21,888	164	2,918	37	1,657
Manufacturing	[illegible]	[illegible]	1,175	36,464	6,875	255,606	792	23,081
Food Products	113	5,444	52	1,335	119	10,609	25	1,007
Textiles	287	6,929	20	717	498	8,722	14	136
Pulp and Paper	55	1,642	10	168	46	1,342	4	*
Publishing and Printing	17	236	2	107	46	993	5	26
Chemicals	641	31,951	147	9,580	766	37,110	101	3,537
Textiles	368	18,676	64	6,648	430	14,754	39	1,983
Fertilizers	114	2,073	17	174	141	2,522	20	342
Pharmaceuticals	331	4,837	30	1,997	107	11,067	23	992
Other	76	2,095	11	123	88	8,779	19	220
Petroleum	154	8,419	148	3,584	98	3,037	9	422
Rubber	56	2,560	5	158	113	3,245	4	43
Glass	241	4,417	50	1,997	141	10,237	18	949
Iron and Steel	187	24,531	135	12,059	417	14,808	51	7,668
Nonferrous Metals	150	5,557	55	917	175	3,623	16	184
Metal Manufactures	59	914	11	72	140	2,816	10	113
Nonelectric Machinery	105	3,330	106	808	1,067	50,810	127	1,585
Electric Machinery	839	18,660	107	4,315	1,847	68,814	254	3,961
Machine Tools	441	8,385	122	1,721	480	25,062	124	698
Electronics	198	18,081	75	2,594	1,367	43,752	130	3,263
Transportation Equipment	572	29,033	80	10,995	949	48,674	87	2,719
Automotive	275	11,788	26	1,462	275	10,855	35	386
Other	297	17,915	54	9,533	674	37,819	52	2,333
Precision Machinery	50	2,000	18	914	247	3,759	37	344
Other	383	6,484	246	823	306	6,996	26	381
Transportation, communications	10	85	6	59	38	438	10	131

Table 1 - continued

c. FY 1982

	Exports				Imports			
	Total		New		Total		New	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Total	4,758	Y184,921	1,970	Y63,336	6,936	Y282,613	929	Y44,439
Agriculture	9	326	2	*	0	0	0	0
Mining	16	921	[illegible]	49	29	293	11	92
Construction	384	19,543	353	17,813	177	2,298	38	213
Manufacturing	4,302	164,058	1,599	45,139	6,692	278,075	841	42,475
Food Products	482	4,728	426	1,962	84	11,286	17	1,168
Textiles	71	6,258	21	540	294	2,821	81	293
Pulp and Paper	82	1,158	62	444	184	1,220	28	153
Publishing and Printing	17	41	4	*	48	1,066	6	22
Chemicals	813	[illegible]	302	7,916	795	45,860	94	8,984
Textiles	423	18,869	185	6,234	459	22,807	48	7,948
Fertilizers	152	[illegible]	11	159	132	2,478	20	104
Pharmaceuticals	194	[illegible]	78	787	118	13,009	16	830
Other	77	[illegible]	19	[illegible]	84	7,566	10	102
Petroleum	18	576	12	317	75	2,909	11	639
Rubber	16	[illegible]	8	68	119	3,475	10	219
Glass	151	[illegible]	75	1,688	142	10,759	20	704
Iron and Steel	382	[illegible]	171	5,983	523	7,800	28	934
Nonferrous Metals	131	[illegible]	45	1,781	171	3,396	18	344
Metal Manufactures	179	[illegible]	59	1,221	200	3,057	8	45
Nonelectric Machinery	316	[illegible]	[illegible]	1,773	927	27,405	101	1,717
Electric Machinery	[illegible]	37,448	[illegible]	6,042	1,835	89,156	247	15,530
Machine Tools	131	[illegible]	[illegible]	908	183	29,681	38	4,611
Electronics	[illegible]	[illegible]	[illegible]	1,643	1,430	59,475	209	10,919
Transportation Equipment	185	[illegible]	75	[illegible]	907	56,413	75	8,872
Automotive	204	[illegible]	31	968	492	16,094	25	4,702
Other	160	[illegible]	42	[illegible]	644	40,319	48	4,170
Precision Machinery	85	[illegible]	46	568	188	3,583	39	1,247
Other	668	[illegible]	516	[illegible]	324	7,858	90	1,623
Transportation, Communications	[illegible]	[illegible]	11	[illegible]	38	1,948	9	1,660

d. FY 1983

	Exports				Imports			
	Total		New		Total		New	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Total	[illegible]	[illegible]	[illegible]	[illegible]	7,333	Y279,280	1,075	Y42,435
Agriculture	[illegible]	[illegible]	[illegible]	*	1	*	1	*
Mining	[illegible]	[illegible]	[illegible]	*	19	188	1	*
Construction	[illegible]	[illegible]	[illegible]	[illegible]	434	4,357	56	259
Manufacturing	[illegible]	[illegible]	[illegible]	[illegible]	6,868	272,858	1,031	42,165
Food Products	[illegible]	[illegible]	[illegible]	[illegible]	384	8,606	15	804
Textiles	[illegible]	[illegible]	[illegible]	[illegible]	271	5,343	14	229
Pulp and Paper	[illegible]	[illegible]	[illegible]	[illegible]	83	546	3	11
Publishing and Printing	[illegible]	[illegible]	[illegible]	*	38	889	1	*
Chemicals	[illegible]	[illegible]	[illegible]	[illegible]	828	42,268	102	4,037
Textiles	[illegible]	[illegible]	[illegible]	[illegible]	430	17,575	66	3,274
Fertilizers	[illegible]	[illegible]	[illegible]	[illegible]	185	5,613	11	200
Pharmaceuticals	[illegible]	[illegible]	[illegible]	[illegible]	222	12,365	16	267
Other	[illegible]	[illegible]	[illegible]	[illegible]	881	5,727	9	290
Petroleum	[illegible]	[illegible]	[illegible]	[illegible]	79	2,690	11	412
Rubber	[illegible]	[illegible]	[illegible]	*	136	5,083	9	204
Glass	[illegible]	[illegible]	[illegible]	[illegible]	470	6,718	16	543
Iron and Steel	[illegible]	[illegible]	[illegible]	[illegible]	809	17,185	33	8,728
Nonferrous Metals	[illegible]	[illegible]	[illegible]	[illegible]	281	5,851	39	185
Metal Manufactures	[illegible]	[illegible]	[illegible]	[illegible]	168	2,808	29	56
Nonelectric Machinery	[illegible]	[illegible]	[illegible]	[illegible]	1,278	28,493	156	3,843
Electric Machinery	[illegible]	[illegible]	[illegible]	[illegible]	1,908	91,921	328	18,056
Machine Tools	[illegible]	[illegible]	[illegible]	[illegible]	378	27,735	38	769
Electronics	[illegible]	[illegible]	[illegible]	[illegible]	1,528	64,186	278	17,287
Transportation Equipment	[illegible]	[illegible]	[illegible]	[illegible]	862	48,916	63	3,260
Automotive	[illegible]	[illegible]	[illegible]	[illegible]	237	10,644	22	237
Other	[illegible]	[illegible]	[illegible]	[illegible]	592	38,272	42	3,023
Precision Machinery	[illegible]	[illegible]	[illegible]	[illegible]	316	4,405	78	1,391
Other	[illegible]	[illegible]	[illegible]	[illegible]	343	5,841	37	392
Transportation, Communications	[illegible]	[illegible]	[illegible]	[illegible]	11	1,852	2	*

*Less than 1¥ million.

Source: Prime Minister's Office, *Report on the Survey of Research and Development*

Table 2: Japan's Corporate Technology Trade by Country, FY 1980-FY 1983

(number of cases and value in billions of yen)

a. Exports

	FY 1980		FY 1981		FY 1982		FY 1983	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Asia	2,862	Y83.6	2,761	Y78.1	2,470	Y111.6	3,084	Y119.2
China	77	9.5	71	4.8	101	4.5	236	18.4
Taiwan	570	9.9	779	12.0	447	9.7	655	10.8
Korea	516	5.3	621	9.5	485	7.5	903	17.0
Thailand	155	4.2	154	5.0	229	5.6	287	6.1
Philippines	108	3.5	90	1.4	127	2.3	131	13.5
Indonesia	383	7.6	165	10.8	227	14.8	273	15.8
North America	800	29.5	789	38.3	784	40.8	1,226	60.0
United States	652	22.1	650	32.6	654	35.6	1,069	53.6
South America	196	10.8	218	11.8	220	10.8	238	10.1
Brazil	95	5.3	107	7.4	110	7.3	133	7.9
Europe	736	29.0	834	32.1	835	39.0	1,597	37.1
Great Britain	98	2.1	119	2.6	118	8.4	469	5.3
West Germany	145	3.4	179	2.9	152	4.7	431	5.1
France	106	2.3	137	4.5	121	3.9	144	4.5
Holland	22	0.7	21	1.2	31	1.0	46	2.4
Switzerland	36	0.5	44	1.6	58	2.1	52	2.1
Africa	129	8.4	146	9.6	314	12.4	137	9.2
Oceania	99	3.2	129	5.2	115	5.5	121	5.3

b. Imports

	FY 1980		FY 1981		FY 1982		FY 1983	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Asia	11	Y0.2	153	0.9	111	0.7	10	0.2
China	0	0	2	0.1	1	*	3	*
Taiwan	2	*	4	*	1	*	2	*
Korea	2	*	42	0.3	41	0.5	1	*
North America	4,267	156.9	4,189	175.9	4,158	188.6	4,757	194.0
United States	4,162	153.8	4,092	171.8	4,062	187.0	4,698	191.1
South America	1	*	2	*	1	*	3	*
Europe	3,931	82.1	2,821	84.4	2,618	92.7	3,025	84.5
West Germany	826	20.5	856	18.9	803	17.8	832	19.6
Britain	700	20.2	586	18.0	462	25.0	480	147
France	421	11.1	334	10.3	333	10.9	401	11.4
Switzerland	428	15.5	265	15.4	326	15.7	335	15.9
Holland	111	6.3	165	10.0	150	12.7	151	11.3
Africa	3	*	4	*	5	0.3	4	*
Oceania	35	0.3	38	0.3	43	0.4	40	0.4

*Less than Y1 billion

Source: Office of the Prime Minister, Report on the Survey of Research and Development

Table 3: Japan's Corporate Technology Trade By Industry By Region, FY 1980-FY 1983

(number of cases and value in millions of yen)

a. FY 1980

	Exports								Imports			
	Asia		North America		South America		Europe		North America		Europe	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Total	1,142	Y78,631	800	Y29,501	196	Y18,842	736	Y29,046	4,267	Y156,862	2,931	Y82,127
Agriculture	2	*	0	0	2	*	0	0	20	1,772	20	700
Mining	[illegible]	99	8	324	2	*	2	*	9	168	23	502
Construction	74	23,516	14	583	8	935	6	112	59	1,475	141	1,201
Manufacturing	[illegible]	55,006	769	28,587	183	9,089	725	28,696	4,154	153,056	2,738	79,619
Food Products	33	1,421	12	46	6	248	15	453	54	2,572	36	7,070
Textiles	43	2,001	11	221	0	0	18	723	91	781	69	1,328
Pulp and Paper	6	175	7	135	0	0	9	235	72	1,187	31	223
Publishing	2	*	3	*	0	0	6	82	26	934	16	24
Chemicals	434	12,227	168	7,038	19	1,321	213	9,698	463	22,478	373	16,726
Textiles	332	10,598	103	5,088	13	1,235	110	7,003	261	10,397	197	6,210
Fertilizers	144	909	17	741	0	0	23	248	75	2,455	44	495
Pharmaceuticals	50	457	41	948	5	51	68	1,512	60	4,308	72	5,854
Other	58	305	7	261	1	*	12	535	67	5,317	60	4,166
Petroleum	8	769	2	*	0	0	3	*	74	8,972	36	706
Rubber	27	1,137	2	5	0	0	5	17	74	2,584	54	1,357
Glass	48	4,084	22	463	3	49	30	3,122	84	3,768	68	5,844
Iron and Steel	78	2,913	60	5,937	47	5,356	102	4,310	136	5,701	155	2,292
Nonferrous Metals	57	535	21	598	17	159	26	501	121	2,203	74	1,440
Metal Manufactures	51	898	6	10	2	*	6	37	116	2,534	100	1,877
Nonelectric Machinery	299	5,391	57	2,342	11	567	67	1,077	860	21,495	750	8,712
Electric Machinery	387	11,221	159	7,192	53	980	83	2,591	1,195	46,804	302	14,834
Machine Tools	148	4,049	64	1,211	26	634	37	1,221	275	16,903	114	4,873
Electronics	231	6,571	95	5,981	27	327	46	1,371	920	29,901	188	9,961
Transportation Equipment	277	9,865	40	1,917	22	493	87	956	513	25,506	425	14,734
Automotive	109	5,070	14	532	5	44	17	187	145	6,351	111	3,978
Other	168	4,795	26	1,385	17	449	70	4,769	368	19,154	314	10,756
Precision Machinery	15	82	162	5,746	1	*	19	451	140	2,213	93	687
Other	151	1,969	192	5,746	0	0	36	307	135	3,324	156	1,763
Transportation, Communications	1	*	4	8	1	*	1	*	25	391	9	105

b. FY 1981

	Exports								Imports			
	Asia		North America		South America		Europe		North America		Europe	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Total	[illegible]	Y78,061	784	Y38,129	218	Y13,770	834	Y32,149	4,189	Y173,901	2,821	Y84,425
Agriculture	8	416	0	0	2	*	0	0	0	0	0	0
Mining	2	180	9	248	0	0	1	*	9	103	22	558
Construction	114	18,703	5	*	16	1,072	14	3,141	51	854	212	2,063
Manufacturing	[illegible]	8,487	776	38,037	148	9,664	815	28,992	4,099	172,618	2,579	81,693
Food Products	89	2,261	7	533	4	*	13	552	75	4,114	40	6,464
Textiles	254	8,276	7	306	0	0	11	782	322	3,987	276	4,735
Pulp and Paper		15	273	*	569	1	*	8	231	60	1,202	16,139
Publishing	2	12	3	*	0	0	7	117	29	950	14	31
Chemicals	228	8,485	177	10,302	27	863	233	11,341	436	21,452	324	15,546
Textiles	108	6,943	112	4,309	14	344	132	59692	243	9,371	184	5,344
Fertilizers	70	1,012	19	733	8	8	22	500	82	1,898	57	611
Pharmaceuticals	14	435	39	4,746	1	58	29	2,055	49	4,006	57	6,990
Other	28	92	7	214	3	*	20	2,594	62	6,178	26	2,601
Petroleum	146	3,908	11	*	2	*	1	*	62	1,599	35	1,422
Rubber	22	1,371	17	16	0	0	7	591	69	1,940	44	1,305
Glass	71	2,225	29	1,027	4	*	34	1,189	83	4,095	56	6,110
Iron and Steel	86	2,758	134	6,342	69	5,735	142	6,471	154	11,927	159	2,818
Nonferrous Metals	74	526	25	737	2	288	29	459	108	2,122	62	1,455
Metal Manufactures	41	476	5	77	1	*	6	5	94	2,046	43	758
Nonelectric Machinery	289	2,604	48	2,144	8	203	39	263	543	23,224	524	7,586
Electric Machinery	406	13,699	234	9,515	55	1,224	110	2,564	1,390	52,219	339	16,353
Machine Tools	211	5,718	127	2,563	23	501	52	753	252	18,755	126	6,150
Electronics	195	7,981	107	6,962	32	724	58	1,811	1,138	33,464	311	10,860
Transportation Equipment	172	13,948	39	3,181	24	903	90	3,046	504	33,728	440	14,918
Automotive	109	7,271	13	539	8	60	15	721	142	6,769	129	4,058
Other	63	6,635	26	2,642	36	842	75	2,325	362	26,959	311	10,860
Precision Machinery	57	1,489	16	487	2	*	20	826	169	2,807	75	947
Other	301	3,472	35	2,411	0	0	45	356	131	5,205	132	1,105
Transportation, Communications	4	*	10	10	2	*	4	*	30	326	8	111

Table 3 - continued

c. FY 1982

	Exports								Imports			
	Asia		North America		South America		Europe		North America		Europe	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Total	2,470	Y77,464	784	Y40,819	220	Y10,803	835	Y38,963	4,058	Y188,561	2,618	Y92,662
Agriculture	3	*	0	0	2	*	0	0	0	0	0	0
Mining	7	198	5	255	0	0	3	*	10	150	18	140
Construction	207	14,705	6	6	8	66	8	141	86	913	90	1,384
Manufacturing	2,245	60,917	763	40,494	209	10,725	816	38,331	4,033	185,705	2,501	90,985
Food Products	450	3,505	9	280	5	249	16	682	50	4,970	32	6,311
Textiles	46	1,788	8	344	0	0	16	3,752	122	705	107	1,967
Pulp and Paper	62	585	9	323	1	*	7	201	127	1,030	37	190
Publishing	5	14	4	*	0	0	6	38	28	991	17	22
Chemicals	299	8,780	218	9,141	28	1,076	256	9,465	427	27,276	361	18,225
Textiles	142	5,962	136	4,593	20	1,007	115	5,135	260	16,647	195	6,131
Fertilizers	87	1,063	18	914	0	0	23	295	72	1,802	60	677
Pharmaceuticals	30	433	55	3,452	6	51	101	2,693	49	4032	68	8,647
Other	40	647	9	382	2	*	17	1,341	46	4,795	38	2,771
Petroleum	11	100	0	0	3	*	1	*	50	1,149	25	1,760
Rubber	23	1,525	7	70	0	0	7	304	71	1,872	48	1,601
Glass	89	4,762	23	487	14	154	33	700	69	4,448	72	6,282
Iron and Steel	103	6,234	87	4,627	31	6,496	155	9,082	142	5,005	177	2,754
Nonferrous Metals	78	1,579	30	349	6	306	33	191	105	2,154	63	1,193
Metal Manufactures	39	1,326	18	128	1	*	6	48	148	2,144	51	909
Nonelectric Machinery	182	2,243	48	2,171	8	130	45	574	519	20,426	404	6,920
Electric Machinery	514	14,171	186	10,453	57	933	97	8,580	1,414	62,005	398	27,064
Machine Tools	210	5,879	65	2,497	27	517	28	712	260	21,970	137	7,702
Electronics	304	8,278	121	7,956	30	415	69	7,869	1,154	40,035	261	19,365
Transportation Equipment	170	11,611	50	6,147	30	1,013	93	3,236	492	43,316	411	13,059
Automotive	115	8,234	15	1,095	13	57	20	2,189	143	12,253	115	3,804
Other	55	2,189	35	5,053	17	956	73	1,047	349	31,064	296	9,255
Precision Machinery	35	1,058	26	405	3	*	18	848	114	2,859	71	639
Other	177	1,726	30	5,535	2	*	27	555	155	5,558	227	2,080
Transportation, Communications	8	466	10	64	1	*	8	328	29	1,792	9	154

d. FY 1981

	Exports								Imports			
	Asia		North America		South America		Europe		North America		Europe	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Total	3,084	Y119,220	1,226	Y60,034	238	Y10,068	1,597	Y37,093	4,757	Y194,000	3,025	Y84,499
Agriculture	5	269	0	0	2	*	0	0	0	0	0	0
Mining	7	387	2	*	1	*	0	0	4	*	10	54
Construction	337	23,359	63	2,317	3	*	15	460	339	3,698	104	698
Manufacturing	2,730	95,046	1,160	57,408	230	9,891	1,576	36,538	4,405	188,317	2,909	83,746
Food Products	91	1,785	10	805	4	*	19	812	38	2,237	28	6,424
Textiles	36	1,418	16	371	0	0	8	351	104	1,027	170	4,516
Pulp and Paper	14	412	12	408	1	*	8	258	25	561	14	85
Publishing	5	*	2	*	1	*	4	*	25	863	12	26
Chemicals	372	9,038	193	10,734	30	653	173	10,188	562	26,188	353	15,876
Textiles	159	6,727	106	3,568	20	553	15	5,586	251	13,535	197	4,036
Fertilizers	102	1,120	23	858	1	*	18	73	84	2,324	61	1,289
Pharmaceuticals	33	343	56	6,131	7	26	116	6,410	156	5,401	65	6,752
Other	78	812	8	179	2	*	24	1,119	71	4,927	30	3,800
Petroleum	11	118	1	*	2	*	5	168	41	1,016	29	1,674
Rubber	20	1,386	0	335	0	0	9	17	80	2,342	56	1,620
Glass	100	6,307	40	1,046	7	70	116	1,377	78	3,789	391	2,937
Iron and Steel	93	14,967	96	3,789	32	6,300	130	11,350	130	13,645	166	3,881
Nonferrous Metals	71	1,688	23	174	7	278	30	141	129	2,737	49	900
Metal Manufactures	68	1,031	21	123	2	*	7	91	94	1,555	73	1,043
Nonelectric Machinery	545	6,377	290	2,552	47	872	195	4,942	735	18,706	538	9,779
Electric Machinery	754	17,959	241	11,572	58	599	144	4,345	1,515	72,149	374	19,721
Machine Tools	230	7,122	91	2,892	37	424	48	947	249	20,166	127	7,560
Electronics	523	10,837	150	8,679	21	175	96	3,398	1,266	51,984	247	12,160
Transportation Equipment	209	10,946	61	7,774	28	630	96	4,109	491	34,440	366	12,399
Automotive	139	8,223	22	3,904	15	197	24	1,888	147	6,543	107	4,071
Other	70	2,717	39	3,869	13	432	72	2,221	344	27,897	259	8,328
Precision Machinery	113	2,957	13	414	4	*	22	554	196	3,530	118	758
Other	231	16,141	132	17,260	6	62	110	1,835	162	3,534	172	2,108
Transportation, Communications	5	*	11	152	2	*	6	55	9	1,852	2	*

*Less than Y1 million

Source: Prime Minister's Office, Report on the Survey of Research and Development

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Japan's Economy Slows In The Third Quarter

Faltering exports and sluggish domestic demand slowed the pace of Japan's economy in the July-September quarter. Gross national product grew at an inflation-adjusted annual rate of only 2.6 percent, compared to 5.8 percent in the preceding three months (see table). The 3.9 percent annual growth rate recorded during the April-September period is below the government's 4.6 percent growth forecast for FY 1985.

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1983	FY 1984	October-December 1984	January-March 1985	April-June 1985	July-September 1985
Gross National Product	Y267,782.0	Y281,102.2	Y284,215.8	Y285,425.7	Y289,447.6	Y291,298.9
	(3.7%)	(5.0%)	(8.9%)	(1.7%)	(5.8%)	(2.6%)
Personal Consumption Spending	155,008.7	159,100.7	159,240.9	161,106.4	161,900.4	162,753.3
	(3.1%)	(2.6%)	(2.2%)	(4.8%)	(2.0%)	(2.1%)
Private Residential Construction	13,635.6	13,688.4	13,742.5	13,913.9	14,227.9	13,892.6
	(-9.0%)	(0.4%)	(3.5%)	(5.1%)	(9.3%)	(-9.1%)
Private Fixed Nonresidential Investment	42,672.2	47,342.6	48,452.9	48,574.5	51,124.5	52,770.0
	(4.9%)	(10.9%)	(17.1%)	(1.0%)	(22.7%)	(13.5%)
Change in Business Inventories	988.8	1,839.1	1,950.7	2,112.0	1,825.3	1,384.0
	(-16.9%)	(86.0%)	(-1.3%)	(37.4%)	(-44.2%)	(-66.9%)
Government Current Expenditures	26,050.2	26,654.9	26,675.0	26,979.1	27,081.5	27,190.4
	(3.5%)	(2.3%)	(2.1%)	(4.6%)	(1.5%)	(1.6%)
Government Fixed Investment	22,848.1	22,159.9	22,014.9	21,615.5	19,954.0	20,456.1
	(-2.2%)	(-3.0%)	(-8.5%)	(-7.1%)	(-27.4%)	(10.5%)
Change in Government Inventories	-227.9	159.1	42.6	27.9	77.6	515.6
	(*)	(*)	(*)	(*)	(*)	(*)
Net External Sector	6,806.2	10,157.3	14,096.4	11,096.4	13,256.4	12,336.9
	(135.8%)	(49.2%)	(408.5%)	(-29.2%)	(103.7%)	(-25.0%)
Exports of Goods and Services and Factor Income Received	46,313.9	53,609.8	55,256.5	54,833.7	57,176.9	55,149.3
	(8.7%)	(15.8%)	(20.9%)	(-3.0%)	(18.2%)	(-13.4%)
Imports of Goods and Services and Factor Income Paid	39,507.7	43,452.4	43,160.1	43,737.3	43,920.5	42,812.4
	(-0.5%)	(10.0%)	(-12.6%)	(5.5%)	(1.7%)	(-9.7%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

In contrast to the 18.2 percent gain in the April-June quarter, real exports in the third quarter fell 13.4 percent, as deliveries to Japan's two largest markets, the United States and China, were flat. Furthermore, shipments to Southeast Asia, a region that has suffered from slower U.S. growth, were also off. If both exports and imports had remained at their second-quarter levels, real economic growth in the July-September period would have been 3.9 percent instead of 2.6 percent.

At the same time, private plant and equipment investment, which together with exports has led the current expansion, also slowed. The annual rate of investment growth fell from 22.7 percent in the second quarter to 13.5 percent in the third quarter. Investment growth in the second quarter, however, was artificially high, since it included for the first time investment by Nippon Telegraph and Telephone Corp. and Japan Tobacco Inc., both of which were privatized in April 1985.

Personal consumption spending remained sluggish, increasing at an annual rate of 2.1 percent. Stable prices, higher spring wage increases and larger summer bonuses had been expected to lead to faster growth in consumer spending. The increase in workers' income, however, has been more modest as a result of less overtime and a slower increase in employment. Moreover, residential housing construction declined sharply in the July-September period despite low interest rates on housing loans and stable land prices.

Government spending increased at a 9.2 percent annual rate in the third quarter following the sharp decline during the preceding three months. Spending was led by government fixed investment, which increased for the first time since the second quarter of 1984.

The slowdown makes it likely that the government forecast of 4.6 percent growth will not be achieved. Economic Planning Agency officials expect the high value of the yen to further soften exports during the October-December period. Moreover, a decline in corporate profits makes an increase in business investment unlikely. The deceleration of growth has also led many forecasters to lower their growth predictions for the coming year. Last week, Ippei Kaneko, EPA's director general, predicted that Japan will not be able to attain a real growth rate of 4 percent in FY 1986, while the Organization for Economic Cooperation and Development forecast a 3.5 percent growth rate for calendar 1986.

The third-quarter statistics were the first GNP figures to be calculated using 1980 as the base year. Use of the new base led to a downward revision of real growth in FY 1984 from 5.7 percent to 5.0 percent. Growth rates in earlier years were revised downward by smaller amounts to 3.3 percent in FY 1981, 3.2 percent in FY 1982 and 3.7 percent in FY 1983.

Randall S. Jones

Mixed Signals On Course Of Japanese Fiscal Policy

Despite slowing economic growth (see article in this issue), the Japanese government remains reluctant to resort to fiscal stimulus. The draft

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YEAR-END REVIEW OF FOREIGN ECONOMIC LEGISLATION

Summary

The first session of the 99th Congress saw renewed pressures on legislators to address the growing U.S. trade deficit. Punitive action against Japan and other nations perceived to be the sources of the trade imbalance grew increasingly attractive, as Congress attempted to strike a rhetorical as well as substantive blow for "fair trade." How to design legislation to achieve a "level playing field" remained unclear, however, as a variety of trade-related proposals gained attention. Among them were attempts to protect domestic industries such as textiles, footwear and telecommunications; calls for across-the-board and/or sector-specific import quotas and tariffs; new approaches to multilateral trade talks; and proposals to substantially alter current trade law remedies. All this was done in the name of establishing a more coherent U.S. trade policy, gaining access to foreign markets, and preserving American jobs.

The Reagan administration, in an effort to restrain the flood of protectionist sentiment, announced a new trade policy offensive, offered several new foreign economic initiatives, and reasserted its legislative priorities by focusing on tax reform and other issues. This only slightly moderated congressional intentions, and highlighted the increasingly tense state of relations between the two branches of government. Overall, 1985 was a year of heightened congressional concern over trade issues -- concern that can only continue during this election year.

An Intense, But Variable First Session

In 1985 the level of protectionist fervor in Congress reached heights unprecedented since the 1930s. But the ebb and flow of Capitol Hill politics, whether it concerned hot political topics or relations with the White House, chronicled the session's inconsistency. The schizophrenic tendencies were attributable to a number of factors, among them the large gap between the congressional mood, its accompanying rhetoric and substantive legislative action, and shifting political alignments between parties and the executive and legislative branches. On top of this, the complexity of the subject allowed for a bewildering array of interrelated topics to be discussed, complicating the popular perceptions of the issues and the manner in which legislators addressed them.

Capitol Hill's attention to trade and other foreign economic matters varied in 1985, with pockets of intensity correlated with events like Japan's March announcement that its voluntary restraints on U.S.-bound car exports would be eased, President Reagan's September decision to ignore the footwear industry's case for import relief, and reactions to the administration's fall trade offensive. Legislators tackled the subject again due to the presidential veto in mid-December of the only major trade protection legislation to pass the Congress -- the textile-footwear-copper bill -- and following the periodic release of worsening trade statistics.

Fascination with different methods of dealing with trade issues, particularly as they concerned this country's relations with Japan, shifted several times. Early on, sectoral protection for the automotive, textile and steel industries, perennial objects of congressional concern, maintained a high profile. As the months went by, country-specific measures became popular, cresting in April in an unprecedented number of "Japan-bashing" proposals. Legislative initiatives on trade widened in scope thereafter, with the introduction of many broad-brush import quota and surcharge bills. By the end of the summer, some 300-odd "protectionist" proposals had stacked up. They were in turn followed in the fall by a series of trade reform packages originating from both party and bipartisan sources in both chambers.

Political alignments on trade issues fluctuated as well. At the beginning of the session the issue of retaliation and protection was primarily presented by the traditional promoters of domestic industry protection: "Rust Belt" representatives from both parties and legislators with specialties in trade. But the usually narrow segment of interested lawmakers expanded as trade became a front-page topic in September. Congress came roaring back from its break declaring that the trade deficit, rather than tax reform, was its number-one priority.

In July partisanship on trade issues came to the fore, as several Democratic leaders brought forth with fanfare an import surcharge proposal and initiated a race with their Republican counterparts to author and direct legislative action on trade. The competition remained intense, even as some elements of bipartisanship re-surfaced in the melange of omnibus trade reform packages that began to appear on the scene in October. Moreover, although some

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observers have dismissed its importance, the debate over textiles brought out regional antagonisms -- conflicting interests between primarily southern states with closing factories, and the farm belt, which feared that tougher import quotas would bring retaliation against U.S. agricultural exports.

Although the session lasted almost two months longer than originally intended, the extra time was spent dealing with such contentious matters as tax reform, deficit reduction, defense, farm legislation and appropriations. The committees responsible for reviewing and approving foreign economic measures, principally the Senate Finance and the House Ways and Means committees, were able to hold several highly publicized hearings on trade during the summer and fall, but were ultimately preoccupied by these other topics. Thus, Congress appeared intermittently fixated on and disassociated from trade and foreign economic issues.

Protracted negotiations allowed the Export Administration Act renewal and foreign assistance appropriations to proceed smoothly to the president's desk. However, as floor time became increasingly difficult to get, only bills with the greatest degree of prearranged support were given a chance for a vote. The trade vehicle that ultimately emerged as the leading indicator of congressional feelings, the Textile and Apparel Enforcement Act (HR 1562, S 680), was brought up several times and eventually passed, but most other trade proposals, by fate or design, languished in committee.

The steady tempo of complaints over forest products, auto carriers and machine tools was joined by a number of new subtopics under the foreign economic relations rubric. Rep. Jack Kemp (R, N.Y.) and Sen. Bill Bradley (D, N.J.) lent their high profile-cum-presidential candidate dazzle to the question of exchange rates and international currency reform with a well-publicized conference on the subject in November. High technology and services trade were both the focus of a large number of informational hearings. Among the few sectoral protection measures that maintained momentum through the end of the year were those concerning competition in high technology markets, such as telecommunications. The close of the session featured renewed discussions about a cut in the investment tax credit and its impact on international as well as domestic investment, and a business transfer tax to raise revenues lost from the across-the-board tax cuts.

The White House's focus on international economics lapsed notably during the spring when U.S. Trade Representative William Brock was moved to the Labor Department and Under Secretary of Commerce for International Trade Lionel H. Olmer resigned. Their replacements, Clayton Yeutter and S. Bruce Smart, respectively, did not settle in until late summer, a development that provoked congressional criticism and contributed to the perception that Mr. Reagan's trade policy was in disarray at a time of crisis.

The administration girded up during the fall congressional furor and under the leadership of Treasury Secretary James E. Baker took a series of policy initiatives to lower the value of the dollar, investigate foreign trade practices targeted as unfair, and establish a new round of multilateral trade negotiations. Mr. Reagan and his aides insisted that their policy was "free and fair trade" with decidedly pragmatic "we'll use the weaponry we've got" enforcement.

In its effort to appear tough, several aspects of the White House's free trade philosophy had to be softened or ignored -- a development greeted with enthusiasm by activists within the administration as well as by many on Capitol Hill. Turnarounds on exchange-market intervention, support for trade adjustment assistance programs and the usefulness of the Export-Import Bank surprised observers. Still, the White House threat to veto any bill perceived as protectionist was implicit, and invoked as promised in the case of the textile bill.

Like everything else, the president's success with Congress fluctuated during 1985. Mr. Reagan's supporters may point to the success of his fall offensive in stymieing the progress of protectionist proposals, but detractors note that the threat from such legislation could have been thwarted by earlier action from the White House. Other conflicts appeared late in the year. The battle over tax reform and deficit reduction highlighted tensions that have always existed and exacerbated sensitivities between the president and members of his own party.

With only three more years to go, any altercations with legislators prompts the observation that Mr. Reagan has reached the lame-duck stage of his presidency, with its paralyzing effect on attempts to influence congressional activity. The unprecedented level of cooperation Mr. Reagan enjoyed for most of his tenure is now history. After all, legislators spent a good part of 1985 thinking about the elections in 1986. The attractions of applying protectionist solutions to unemployment occurred to both parties. Once loyal Republicans realized how little the president, even one as popular as Mr. Reagan, would help them out on a topic so fundamentally repugnant to his free trade philosophy, no matter how pragmatic he claimed to be. Many determined to distance themselves from the White House on the subject. Overall, the Congress began to go its own way in 1985 regarding foreign economic affairs, and will continue to do so in 1986.

Legislative Activity

For all the emotion and rhetoric, Capitol Hill's output during the calendar year, in terms of bills enacted or even brought to a vote, was terribly small. Japan received two distinct slaps on the hand: a non-binding resolution in March calling for retaliation because of Japan's perceived failure to open domestic markets (see JEI Report No. 14B, April 12, 1985), and a call for an acceleration of Tokyo's defense spending that was tacked on to the foreign aid authorization bill in June (see JEI Report No. 23B, June 21, 1985). Another small jab at Japan: legislation requiring a 25 percent reduction in funding for the Japan-U.S. Friendship Commission.

These moves caused expected dismay in Tokyo and added impetus to the formation and implementation of Prime Minister Yasuhiro Nakasone's "action program." Tokyo's efforts did little or nothing to assuage Capitol Hill, however, as the urge to target Japan continued. At the same time, a closer examination of what fuels Japan's competitive edge resulted in Senate passage of the Japanese Technical Literature Act (S 1073), a program to provide increased transfers of technical information between the American and Japanese private and government sectors (see JEI Report No. 46B, December 6, 1985).

After two years of work, Congress renewed the Export Administration Act June 27. The measure regulates export flows for security, foreign policy or economic reasons, providing tougher penalties for violators and limiting the president's power to impose embargoes against foreign countries. The bill also streamlines the paperwork for U.S. exporters by easing licensing regulations covering Western Europe and Japan and exempting low technology and agricultural goods from controls. Although great relief was expressed after the bill's passage, the EAA still elicits controversy on Capitol Hill (see JEI Report No. 44B, November 15, 1985) and various efforts remain under way to tinker with its provisions.

As the session wound down, both chambers approved the conference report on the farm bill (HR 2100) with a provision that mandates the government to improve the competitiveness of U.S. agricultural exports through the disbursal of $2 billion worth of surplus commodities and expanded programs for short- and medium-term export credit guarantees. Singled out for at least $325 million a year of assistance for FY 1986-88 are commodities facing "subsidies, import quotas or unfair trade practices of foreign countries." Export assistance of another sort suffered drastic cutbacks, however. Under the continuing appropriations measure passed and signed by the president December 19, the Export-Import Bank's lending authority was slashed to only $1.1 billion for FY 1986. The program was allocated $3.9 billion in FY 1985.

The status of programs to aid industries and workers hurt by imports remained up in the air as legislators left Washington. Out of patience and energy concerning the budget reconciliation compromise, the Senate sent the measure back to conference committee before adjourning December 20. Preserved in it is a plan to alter present trade adjustment assistance programs by eliminating the loan portion of the program, expanding the number of firms eligible for assistance and changing the system of cash payments made to workers. The programs would be financed through a one percent levy on imports, an idea promoted assiduously by Sen. William Roth (R, Del.).

Stopgap funding measures provide some resources for TAA, but only long-term financing will salvage the program. The White House has threatened to veto any measure that includes an import fee; at the same time it has changed its short-term policy on TAA dramatically. Rather than trying to eliminate TAA altogether, as in previous years, a cabinet-level working group is considering revising the program. Indicating the administration rethink, the president announced his support for an additional $100 million in appropriations for worker re-training programs supervised by the Labor Department during the final days of congressional deliberation.

The only protectionist trade legislation passed by both chambers last year -- other than a mildly xenophobic declaration making December "Made in America" month -- was the Textile and Apparel Trade Enforcement Act of 1985, sponsored in the House by Rep. Ed Jenkins (D, Ga.) and in the Senate by South Carolina Sens. Strom Thurmond (R) and Ernest Hollings (D). The bumpy evolution of this measure paralleled the congressional approach to trade, with components of rhetorical fervor, fluctuating momentum of personal and party politics, complex floor tactics and influential administration views.

In its first incarnation, the bill required drastic cutbacks on all textile imports except those from Canada and the European Community. With a strong push from industry and labor groups, the measure enjoyed the backing of over two-thirds of each chamber. By the time of its final approval December 3, the required import restrictions were milder and, due to the president's refusal to uphold an International Trade Commission decision on import protection for the shoe industry, included provisions on footwear as well as a politically expedient section designed to aid the copper industry.

Overshadowing the action was the constant threat of a presidential veto. The popular perception was that the White House and congressional opponents of the measure were going to let the protectionists go through the motions with this vehicle. By November enthusiasm for the measure had indeed dimmed, particularly in the Senate where serious defections and a series of filibuster threats caused Sens. Thurmond and Hollings to go through elaborate tactical contortions to get a vote on the bill. In the end the floor votes in both chambers tallied far less than the two-thirds required to override the presidential veto (see JEI Report No. 40B, October 18, 1985), enacted December 17 at the eleventh hour.

Indications are that textile backers will hold off on an override attempt until early August in order to reorganize support at a time more politically ripe for restrictive action. The summer attempt would coincide with a new round of multilateral negotiations on the Multi-Fiber Arrangement and fall advantageously close to the 1986 elections. The textile debate continues to heavily influence legislative activity, however, due principally to a publicly played-out argument between Sens. Hollings and John Danforth (R, Mo.) that has blocked consideration of other trade vehicles.

The Attention-Getters

Other legislative options that captured Congress' somewhat fractured attention included the following:

Unfair Trade Practices and Telecommunications Access - Throughout the fall the betting money was on S 1404, the Unfair Trade Practices of Japan bill sponsored by Finance Committee Chairman Bob Packwood (R, Ore.), and S 942/HR 3131, measures threatening sanctions in order to open foreign markets to U.S. telecommunications products, pushed by Sen. Danforth and Reps. Timothy Wirth (D, Co.) and James Florio (D, N.J.). S 1404, the binding version of the March condemnation of limited Japanese market access, was ready for floor action by late summer, while the telecommunications proposals, which differ slightly in each chamber, were given steady attention and prompt approval by the committees they were initially referred to.

Since the telecommunications measure was stymied in the House by the Ways and Means Committee's preoccupation with tax reform, the Senate became the main forum for action during 1985. Both the unfair Japanese trade practices measure and the telecommunications bill were potentially such powerful weapons, with a myriad of implications for ongoing negotiations with Tokyo, that Sen. Danforth and sympathetic Majority Leader Robert Dole (R, Kan.) tried to time their floor appearances carefully. A last-minute plan to bring both to a dramatic vote under a unanimous consent agreement was thwarted by an angry Sen. Hollings, who accused the Republicans of bottling up the textile bill in the Finance Committee and playing partisan politics with trade (see JEI Report No. 1B, January 10, 1986). Sen. Hollings attached the textile bill to both measures as well as to several other major trade initiatives. Before either bill can make a reappearance, some kind of accommodation with the senator must be reached.

Trade Reform Packages - One of the most significant legislative developments in 1985 -- and part of the backlash over protectionism from more moderate forces on the Hill -- was the compilation of omnibus trade reform bills stemming from both partisan and non-partisan working groups on both sides of the Hill. At their best, these measures, including HR 3522, HR 3777, S 1837 and S 1860, represent a fundamental, often constructive, reworking of trade remedy law. They also attempt to formulate a more comprehensive trade policy and implement an ambitious restructuring of the trade management bureaucracy. At their worst, they are a grab bag of sectoral protection and barrier-raising notions that would restrict rather than restructure world trade.

In retrospect, 1985 was a time of laying the wide range of propositions on the table and beginning the idiosyncratic process of consolidation. Once again, the House Ways and Means Committee is the key to the evolution of such legislation: whatever comes out of Rep. Dan Rostenkowski's (D, Ill.) January retreat (see below) will set the tone for the second session's activity. Moreover, not without a little influence will be Mr. Reagan's own "wish list" for trade reform, which includes a $300 million export subsidy "war chest," legislation on intellectual property, antidumping remedies applicable to non-market economies, negotiating authority for a new round of multilateral trade negotiations and action on antitrust law.

Import Surcharge - When Rep. Rostenkowski, Rep. Richard Gephardt (D, Mo.) and Sen. Lloyd Bentsen (D, Tex.) introduced their 25 percent import surcharge proposal in July (HR 3035, S 1449), it was the most severe, politically charged legislative option around. As details about the drastic economic side effects of such a surcharge were publicized and congressional interest in textiles, as well as more constructive legislation was galvanized, support for the initiative evaporated. It is still, however, a potent option for protectionists as a trade reform package is assembled. At the same time, even its three main sponsors have acknowledged that rather than serving as a viable policy option, its introduction served several short-term political purposes, i.e., it drew national attention to trade issues, dramatized the Democrat's ability to come up with answers and provided publicity for the sponsors themselves.

Mixed Credits - The legislative centerpiece of White House trade policy is a $300 million "war chest" to provide a mix of grants and low-cost loans to U.S. firms bidding on foreign projects to combat the proliferation of that very practice by other industrialized countries. Most of the progress on the legislative version of the mixed credit program occurred in the House, where HR 3667 weathered controversies over the program's administration (Treasury Department or the Export-Import Bank), the implications for the continued existence of the Eximbank, and sources of funding. Overlapping committee jurisdictions also slowed the bill down; although it passed the House Banking Committee, it faces Foreign Affairs in January. In the Senate broad support at the committee level was tempered by the opposition of a few legislators determined to fight against giving the Eximbank added authority during what was supposed to be a Reagan administration-sanctioned phaseout marked by funding cutbacks.

Other Proposals

Part of the fallout from Capitol Hill's preoccupation with foreign economic issues was the submission of a large volume of legislation. Most of these measures are unlikely to see major action in coming months; their significance is the width and breadth of congressional concern they represent. Exhortative resolutions concerning Japan, particularly those attempting to link defense spending and trade issues, multiplied during the year, as did bills singling out specific industries and even certain products. The narrowness of some of these measures is almost comical: near the close of the session Sen. Frank Murkowski (R, Alaska) submitted a bill demanding tariff protection for U.S. production of fish paste, called surimi, for example.

Despite the focus on the high technology sector, which includes new interest in what the Congress can do in the ongoing battle over semiconductor trade, some proposals concerning auto industry protection remain available for action, including a proposition by Rep. John Dingell (D, Mich.) concerning reciprocal auto safety certification (HR 2248) and measures urging the use of U.S. bottoms to deliver auto imports (S Res 223, HR 3655).

Similarly, the issue of natural resource subsidies continues to generate attention in hearing rooms on both sides of the Hill, and a bill that would apply countervailing duties to subsidized raw material inputs (HR 2451) has already won approval from a Ways and Means subcommittee. The hearings on the topic dealt principally with U.S. problems with the Canadian lumber industry, but also emphasized difficulties in U.S. forest products trade with Japan.

The natural resource subsidy issue has its own momentum, whether it is subsumed under trade law reform or not. Other complex legislative options that received special notice in 1985 and that will continue to interest Congress concern international currency stabilization (HR 3573, HR 3874, S 1548 and S 1571) and negotiating objectives for a new round of multilateral trade talks (all trade packages, but particularly HR 3777, S 1860). Moreover, discussions concerning loosening antitrust regulations for firms involved in stiff international competition (S 1934) and the trade benefits of a business transfer tax (permutations of S 1102) or some other value-added tax should intensify in coming months.

Outlook for 1986

Trade issues will continue to preoccupy Congress in 1986, overlaid with a patina of retaliation and condemnation aimed at Japan. To U.S. legislators, Tokyo is undeniably linked to the trade crisis: cries of unfairness and calls for protectionism usually cite Japanese examples. Even during the debate on textiles, a sector almost insignificant in terms of the trade deficit with Japan, problems with Japanese semiconductors, telecommunications equipment, even baseball bats, were decried. To the Congress, problems with international trade and Japan are all of a piece.

At adjournment House Speaker Thomas "Tip" O'Neill (D, Mass.) announced that the next topic the chamber would concentrate on would be trade legislation. Similarly, Ways and Means chairman Rostenkowski indicated that members of his committee would meet for an intensive weekend retreat to contemplate options for trade law reform during January, a plan reminiscent of the consensus-building process the aggressive Illinois Democrat employed on the tax reform bill. On the Senate side, despite the ongoing squabbling, one of a number of Japan-targeted bills seems likely to get to the floor early in the new year. Add to this the influence of both domestic and international economic news and the congressional calendar, and the passage of a number of trade-related bills seems more likely than ever.

Congress will maintain close scrutiny over progress in sectoral negotiations, Tokyo's efforts to open its markets and expand domestic demand, and its management of the yen. The climate of the first few months of the session will become fiercer, aided by the release of 1985 trade data that will show a record-shattering trade deficit between the United States and Japan. The impact of Treasury Secretary Baker's dollar-lowering program and the resulting rise in the yen is not expected to affect the flow of imports for several months -- creating a readjustment period too long to have any positive influence over Capitol Hill's trade momentum.

As elements of both protectionist and trade reform proposals, separately or combined, move ahead, the White House is likely to be engaged in intense bargaining with legislators. Exactly how much the president is willing to give and take will be a key issue in 1986, particularly regarding the shape of the omnibus trade reform packages. Consideration of such complex legislation may be hampered, moreover, by the brevity of the second session -- currently scheduled to end October 3. Add to this the difficulty of educating members on the intricacies of existing law, the high profile of tax reform, and the time pressures produced by the new mandatory budget-cutting calendar, and it becomes clear that a floor vote before adjournment would be a triumph for trade reform backers.

Still, one must not underestimate the power of emotional debate and the call of an election year, providing momentum for both short- and long-term consideration of trade issues. If a trade bill passes within the first few months of the second session, more likely than not it will be one of the "quick and dirty" initiatives so attractive to legislators facing re-election campaigns. The bills targeting Japan are the surest vehicles. But whether or not Congress starts to take out its frustrations by voting early, foreign economic policy issues will remain in the forefront in 1986 in a variety of incarnations.

For further information, contact Sheri Hoptman.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix 1: 99th Congress Data, First Session

	House	Senate	Total
Days in session	152	170	--
Public bills enacted	93	94	187
Private bills enacted	--	--	--
Total measures passed	596	583	1,179
Total measures reported	387	477	864
Measures pending on calendar	52	94	--
Total measures introduced	5,126	2,651	7,777
Quorum calls	43	20	--
Yea-nay votes	255	381	--
Recorded votes	184	--	--
Bills vetoed	4	--	4
Vetoes overridden	1	1	1

Appendix 2: Legislative Update, 99th Congress

Actions Affecting U.S.-Japan Relations

Bill Number (Sponsor+Cosponsors)	Description Latest Action (Latest JEI Report
H Con Res 23 (Roe +1)	Moratorium on commercial whale harvesting. Introduced 1/3/85; referred to Foreign Affairs Committee; no further action.
H Con Res 27 (Neal + 0)	Japanese payment of security fee to U.S. Introduced 1/7/85; referred to Foreign Affairs Committee; no further action.
H Con Res 54 (Bonker + 63)	Sense of Congress on implementation of international whaling moratorium. Introduced 2/7/85; referred to Foreign Affairs Committee; approved by Foreign Affairs Committee 9/19/85; no further action.
H Con Res 63 (Michel + 27)	Ties continuation of automobile export restraints by Japan to U.S. access to Japanese domestic market. Introduced 2/20/85; referred to Ways and Means Committee; no further action.
H Con Res 93 (Durbin + 15)	Urges extension of Japanese voluntary restraint agreement on automobiles. Introduced [illegible]21/85, referred to Ways and Means Committee, no further action.
H Con Res 103 (Bereuter + 0)	Resolution relating to U.S.-Japan trade. Introduced 3/28/85; referred to Ways and Means Committee, no further action.
H Con Res 105 (Michel + 0)	Resolution concerning U.S.-Japan trade. Introduced 4/1/85; referred to Ways and Means Committee; no further action.
H Con Res 106 (Dingell + 48)	Urges president to respond to Japanese trade practices adversely affecting U.S. interstate commerce. Introduced 4/2/85; referred to Ways and Means, Energy/Commerce Committees; no further action.
H Con Res 107 (Rostenkowski + 19)	Calls for retaliation against Japan. Approved by House, 394-19, 4/2/85; placed on Senate Legislative Calendar 4/4/85. (14B, 4/12/85).
H Con Res 108 (Kostmayer + 0)	Condemns alleged Japanese unfair trade practices. Introduced 4/2/85; referred to Ways and Means Committee; no further action.
H Con Res 258 (Dornan + 0)	Urges moratorium on commercial whale killing. Introduced 12/11/85; referred to Foreign Affairs Committee, no further action.
H Res 247 (Jeffords + 15)	Links Japanese trade practices and U.S.-Japan security relations. Introduced 7/31/85; referred to Foreign Affairs Committee; no further action.
H Res 298 (Watkins + 0)	Establishes Ad Hoc Committee on Trade Policy. Introduced 10/7/85; referred to Rules Committee; no further action.
H Joint R 238 (Stark)	Special Trade Management Act. Introduced 4/4/85; referred to Ways and Means; no further action.
H Joint R 430 (Broyhill + 179)	Made in America Month Designation. Introduced 11/13/85; see S.J.R. 206.
HR 320 (Erdreich + 10)	Creates Department of Trade. Introduced 1/3/85; referred to Government Operations Committee; no action (12B, 3/29/85).
HR 539 (Murtha + 141)	Establishes quotas on imported steel products. Introduced 1/21/85; referred to Ways and Means Committee; no further action.
HR 1050 (Dingell + 58)	Limits automobile imports to 15% of U.S. market. Introduced 2/7/85; referred to Energy/Commerce, Ways and Means Committees; no further action.
HR 1060 (Lundine + 12)	Continues voluntary automobile export restraints until end of 1985. Introduced 2/7/85; referred to Ways and Means Committee; no action.
HR 1139 (Schultz + 3)	Establishes import surcharge. Introduced 2/19/85; referred to Ways and Means, Rules Committees; no action (12B, 3/29/85).
HR 1347 (Dornan + 4)	Export Administration Act amendment to prohibit imports from foreign businesses that export certain goods to communist countries. Introduced 2/28/85; referred to Foreign Affairs Committee; no further action.

HR 1350 (Hertel + 0)	Establishes domestic content requirements for automobiles sold in the U.S. Introduced 2/28/85; hearings by Ways and Means Trade Subcommittee 2/28/85, 3/4/85; referred also to Energy/Commerce Committee (44A, 11/16/84).
HR 1562 (Jenkins + 290)	The Textile and Apparel Trade Enforcement Act of 1985. Quotas on textiles and apparel, import licensing. Introduced 3/19/85; approved by Ways and Means Committee 9/26/85; passed House 262-159, 10/10/85; House concurred with Senate amendments 255-161, 12/3/85; vetoed by president 12/17/85; override attempt delayed until August 6, 1986 12/17/85 (46B, 12/6/85).
HR 1648 (Bonker + 42)	Expansion of international trade in wood products. Introduced 3/21/85; referred to Ways and Means Committee; no further action.
HR 1679 Regula + 9)	Establishes a Department of Trade. Introduced 3/21/85; (referred to Government Operations Committee; no further action.
HR 1786 (Bonker + 1)	Reauthorization and amendment of the Export Administration Act. Introduced 3/28/85; passed House by voice 6/27/85 (26B, 7/12/85); Foreign Affairs subcommittee hearing 11/8/85 (44B, 11/15/85).
HR 1808 (LaFalce + 6)	Amendments to International Trade and Investment Act. Introduced 3/28/85; referred to Ways and Means, Banking/Finance/Urban Affairs, Energy/Commerce, Foreign Affairs, Education/Labor Committees; no action.
HR 1857 (Lundine + 6)	Amends Export-Import Bank Act to provide competitive export financing. Introduced 4/1/85; referred to Banking/Finance/Urban Affairs Committee; no further action.
HR 1858 (Lundine + 6)	Promotes industrial revitalization through establishment of Economic Cooperation Council and other institutions. Introduced 4/1/85; referred to Banking/Finance/Urban Affairs Committee; no action.
HR 1859 (Lundine + 6)	Trade Law Reform and Enforcement Act. Strengthens existing remedies for injurious international trading practices. Introduced 4/1/85; referred to Ways and Means Committee; no action.
HR 1860 (Lundine + 7)	Expansion of U.S. foreign investment linked with participation in the international financial system and U.S. development policy. Introduced 4/1/85; referred to Banking/Finance/Urban Affairs, Foreign Affairs, Ways and Means Committees; no further action.
HR 1892 (Kaptur + 7)	Analysis and redress of U.S. trade imbalance with Japan. Introduced 4/2/85; referred to Ways and Means; no further action.
HR 1926 (Pease + 23)	Trade Adjustment Assistance Act renewal. Introduced 4/2/85; referred to Ways and Means Committee; hearing by Ways and Means subcommittee 6/24/85; (26B 7/26/85).
HR 1944 (Hillis + 3)	Import surcharge on Japanese products. Introduced 4/3/85; referred to Ways and Means Committee; no action.
HR 1950 (Guarini + 95)	Trade Law Modernization Act. Introduced 4/3/85; referred to Ways and Means, Energy/Commerce Committees; hearings 6/26/85. (25B, 6/5/85).
HR 2006 (Kaptur + 0)	Quotas on Japanese auto imports. Introduced 4/4/85; referred to Ways and Means Committee; no further action.
HR 2015 (Regula + 10)	Tariff surcharge to offset cost of U.S. defense assistance. Introduced 4/4/85; referred to Ways and Means Committee; no further action.
HR 2037 (Rinaldo + 0)	Protection of telephone terminal equipment industry. Introduced 4/15/85; referred to Energy/Commerce Committee; no further action.
HR 2115 (Fiedler + 5)	Response to unfair foreign trade practices initiated by Congress. Introduced 4/18/85; referred to Ways and Means; no further action.
HR 2120 (Lundine + 2)	Import surcharge tied to deficit reduction. Introduced 4/18/85; referred to Ways and Means; no further action.
HR 2156 (Hunter + 6)	Expansion of Japanese market for U.S. agricultural products. Introduced 4/22/85; referred to Ways and Means Committee; no further action.
HR 2248 (Wirth + 12)	Amendment to authorization requiring reciprocity in auto import certification measures. Introduced 4/25/85; approved for full Energy/Commerce Committee consideration by subcommittee 6/18/85 (24B, 6/28/85).

HR 2341 (McCurdy + 1)	Tariffs on martial arts uniforms. Introduced 5/2/85; referred to Ways and Means Committee; no further action.
HR 2345 (Moore + 0)	Definition of natural resource subsidies. Introduced 5/2/85; referred to Ways and Means; trade subcommittee hearings 5/15/85, (22B, 6/14/85).
HR 2354 (Anthony + 8)	Tariffs on motor fuel and byproducts. Introduced 5/6/85; referred to Ways and Means Committee; no further action.
HR 2451 (Gibbons + 63)	Amendment to Tariff Act of 1930, applies countervailing duties to natural resource input subsidies. Introduced 5/9/85; hearings by Ways and Means trade subcommittee 6/6/85, approved for full committee as amended 10/24/85, (42B, 11/1/85).
HR 2582 (Bryant + 17)	Reciprocity in international investment policy. Introduced 5/22/85; referred to Energy/Commerce, and Banking/Finance/Urban Affairs Committees; no action.
HR 2607 (Donnelly + 31)	Strengthen U.S. competitiveness in international trade and response to unfair trade practices. Introduced 5/23/85; referred to Ways and Means; no action.
HR 2809 (Murtha + 14)	Trade Law Reform package. Introduced 6/19/85; referred to Ways and Means; no further action.
HR 2934 (Bedell + 0)	Fair Rate of Exchange Act. Introduced 7/9/85; referred jointly to Ways and Means, Foreign Affairs Committees; no further action.
HR 3035 (Rostenkowski + 101)	Trade Emergency and Export Promotion Act including 25% import surcharge. Introduced 7/18/85; referred to Ways and Means Committee; trade subcommittee hearing 9/17/85 (37B, 9/27/85).
HR 3075 (McDade + 0)	Amendment to Trade Act of 1974 to insure reciprocal trade opportunities. Introduced 7/24/85; referred to Ways and Means, Foreign Affairs, Energy/Commerce, Judiciary, Rules Committees; no further action.
HR 3131 (Wirth + 37)	Retaliation against barriers to U.S. telecommunications products. Introduced 7/31/85; referred to Energy/Commerce Committee; approved by two subcommittees 10/2,3/85; approved by full committee 11/21/85; requested by Ways and Means Committee for review (46B, 12/6/85).
HR 3296 (Johnson + 8)	Mixed credits program. Introduced 9/12/85; referred to Banking/Finance/Urban Affairs, Foreign Affairs Committees; Foreign Affairs subcommittee hearings held 10/2,16,22/85; Banking subcommittee hearing held 10/23/85 (45B, 11/22/85).
HR 3350 (Markey + 0)	Telecommunications fair trade bill. Introduced 9/18/95; referred to Ways and Means, Energy/Commerce Committees; no further action.
HR 3439 (Matsui + 9)	Telecommunications Trade Act. Introduced 9/26/85; referred to Ways and Means, Energy/Commerce Committees; no further action.
HR 3515 (Wylie + 63)	Export financing program-mixed credits. Introduced 10/7/85; referred to Banking/Finance/Urban Affairs, Foreign Affairs; Foreign Affairs subcommittee hearings 10/2,16,22/85; Banking subcommittee hearings 10/23/85 (47B, 12/13/85).
HR 3522 (Michel + 127)	House Republican trade reform package. Introduced 10/8/85; referred to Ways and Means, Banking/Finance/Urban Affairs, Judiciary, Energy/Commerce Committees; no further action (41B, 10/25/85).
HR 3535 (Dornan + 0)	Controls on export of capital from U.S. Introduced 10/09/85; referred to Foreign Affairs Committee; no further action.
HR 3573 (Lundine + 21)	Concerns exchange rate controls, international monetary talks. Introduced 10/16/85; referred to Banking/Finance/Urban Affairs, Ways and Means Committees; marked up by Banking subcommittee 12/04/85.
HR 3636 (Sundquist + 2)	Establishes a Department of Trade. Introduced 10/28/85; referred to Government Operations Committee; no further action.
HR 3655 (Jones + 14)	Countering restrictive practices in marine transport of autos. Introduced 10/30/85; referred to Merchant Marine, Ways and Means Committees; no further action.
HR 3667 (Neal + 7)	President's $300 million mixed credits proposal. Introduced 10/31/85; referred jointly to Banking/Finance/Urban Affairs, Foreign Affairs Committees; Banking Committee approval 12/20/85; sequentially referred back to Foreign Affairs until 2/7/85 (47B, 12/13/85).

HR 3668 (Pease + 15)	Trade package including dollar alignment, trade remedy modification, import relief. Introduced 10/31/85; referred to Ways and Means Committee; no further action.
HR 3736 (Lowery + 11)	Controls on export of capital from the U.S. Introduced 11/12/85; referred to Foreign Affairs Committee; no further action.
HR 3776 (Moorhead + 11)	Enhancement of patent, trademark and copyright infringement. Introduced 11/18/85; referred to Judiciary Committee; no further action.
HR 3777 (Dingell + 36)	Omnibus trade reform package. Introduced 11/19/85; referred to Energy/Commerce, Ways and Means Committees; reported as amended by Energy/Commerce 11/21/85.
HR 3803 (Traficant + 2)	Labeling of commodities to indicate foreign and domestic content. Introduced 11/20/85; referred to Energy/Commerce Committee; no further action.
HR 3813 (Fazio + 6)	American Trade Reform Act. Introduced 11/21/85; referred to Banking/Finance/Urban Affairs, Education/Labor, Foreign Affairs, Energy/Commerce, Judiciary, Science and Technology, Ways and Means Committees; no further action.
HR 3817 (Manton + 1)	Restrictions on Cook Inlet oil exports. Introduced 11/21/85; referred to Foreign Affairs Committee; no further action.
HR 3831 (Mineta + 3)	Japanese Technical Literature Act (see S 1073). Introduced 11/21/85; referred to Science and Technology Committee.
HR 3839 (LaFalce + 0)	Exchange rates and trade competitiveness. Introduced 12/3/85; referred to Banking/Finance/Urban Affairs Committee; no further action.
HR 3847 (McEwen + 0)	Amendments to Trade Act of 1974 to eliminate trade barriers, negotiating authority to president, export promotion. Introduced 12/3/85; referred to Ways and Means, Banking/Finance/Urban Affairs, Judiciary, Foreign Affairs, Energy/Commerce Committees; no further action.
HR 3872 (Armey + 6)	International competitiveness of the U.S. Introduced 12/6/85; referred to Foreign Affairs, Government Operations, Energy/Commerce, Judiciary Committees; no further action.
HR 3874 (LaFalce + 0)	Competitive Exchange Rate Act. Introduced 12/6/85; referred to Banking/Finance/Urban Affairs Committee; no further action.
HR 3990 (Sweeney + 0)	Comprehensive trade law reform. Introduced 12/18/85; referred to Banking/Finance/Urban Affairs, Ways and Means Committees; no further action.
S Con Res 15 (Danforth)	Nonbinding resolution calling for retaliation against Japan for perceived failure to open domestic markets. Approved by Senate, 92-0, 3/28/85; approved by Finance Committee as legislation, 12-4, 4/2/85 (14B, 4/12/85).
S Con Res 23 (Baucus + 11)	Urges reduction of Japanese trade barriers. Introduced 2/27/85; referred to Finance Committee; no further action.
SR 215 (Murkowski + 0)	Calls Japanese market opening measures inadequate. Introduced 8/1/85; referred to Finance Committee; no further action.
SR 223 (Murkowski + 1)	Use of U.S. bottoms for auto imports. Introduced 9/18/85; referred to Finance Committee; no further action.
S J R 206 (Thurmond + 30)	Made in America Month. Introduced 9/24/85; passed Senate by voice 12/2/85; became law 12/11/85 (48B 12/20/85).
S 11 (Heinz + 44)	Establishes import quotas on steel products. Introduced 1/3/85; referred to Finance Committee; no action (14B, 4/12/85).
S 21 (Moynihan + 0)	Creates Department of International Trade and Industry. Introduced 1/3/85; referred to Governmental Affairs Committee; no further action (12B, 3/29/85).
S 234 (Roth + 3)	Trade Expansion Act. Authorizes new multilateral negotiating round; worker retraining programs; revision of domestic trade laws. Introduced 1/22/85; referred to Finance Committee; subcommittee hearing 9/17/85.
S 236 (Specter + 8)	Revises U.S. antidumping laws. Introduced 1/22/85; referred to Judiciary Committee; no action (14B, 4/12/85).
S 339 (Lautenberg + 15)	Software protection, establishing reciprocity as standard for extending U.S. copyright protection to software of other countries. Introduced 3/1/85; referred to Judiciary Committee; no action (8B, 3/1/85).

S 450 (Bingaman + 0)	Mandates international trade and export policy study. Introduced 2/7/85; referred to Governmental Affairs Committee; no further action.
S 609 (Byrd + 0)	Amends the Trade Act of 1974 to insure fair trade opportunities. Introduced 3/7/85; referred to Finance Committee; no further action.
S 680 (Thurmond + 54)	Textile and Apparel Trade Enforcement Act. Import quotas on textiles. Introduced 3/19/85; House version approved by Senate as amended 60-39 11/13/85; vetoed by president 12/17/85 (48B, 12/20/85).
S. 728 (Chafee + 1)	Establishes quantitative retrictions on imports of Japanese telecommunications products. Introduced 3/20/85; hearings adjourned by Finance subcommittee on international trade 5/3/85 .
S 761 (Murkowski + 0)	Import surcharge. Introduced 3/26/85; referred to Finance Committee; no further action.
S 770 (Heinz + 1)	Import surcharge on all U.S. imports from Japan. Introduced 3/28/85; referred to Finance Committee; no further action.
S 774 (Chiles + 2)	U.S. export promotion through elimination of Japanese nontariff trade barriers. Introduced 3/28/85; no further action.
S 883 (Heinz + 0)	Export Administration Act extension. Introduced 4/3/85; passed Senate 4/3/85; became law 7/12/85 (26B, 7/12/85).
S 906 (Gorton + 2)	Blanket import surcharge on goods from Japan and other countries with major bilateral trade deficits. Introduced 4/16/85; referred to Finance; no action.
S 942 (Danforth + 15)	Telecommunications Trade Act of 1985. Reciprocal telecommunications market access bill. Introduced 4/17/85; approved by Finance Committee as amended (incorporates certain provisions of S 728) 9/17/85; filed for floor action 12/2/85; textile amendment by Hollings 12/18/85; awaiting clearance for floor consideration (48B, 12/20/85).
S 982 (Heinz + 5)	Retaliation against Canadian lumber exports. Introduced 4/23/85; referred to Finance Committee; subcommittee hearing 10/16/85 (37B, 9/27/85).
S 1073 (Baucus + 4)	Japanese Technical Literature Act of 1985 to approve availability of science and engineering materials to the U.S. Introduced 5/6/85; passed Commerce Committee as amended 9/11/85; passed Senate by voice 11/23/85 (46B, 12/6/85).
S 1102 (Roth + 0)	Imposes Business Transfer Tax. Introduced 5/8/85 referred to Finance Committee; hearing 10/10/85.
S 1356 (Heinz + 5)	Trade Law Modernization Act. Introduced 4/3/85; hearings by Commerce Committee 5/26/85 (25B, 7/5/85).
S 1404 (Packwood + 0)	Requires presidential action against Japanese unfair foreign trade practices. Filed by Finance Committee 7/9/85; textile amendment by Hollings 12/18/85; awaiting clearance for Senate floor consideration (48B, 12/20/85).
S 1449 (Bentsen + 11)	Trade Emergency and Export Promotion Act including 25% import surcharge. Introduced 7/17/85; referred to Finance Committee; no further action (28B, 7/26/85).
S 1476 (Mitchell + 4)	Fair Foreign Trade Practices Act. Modifies Section 301 to give USTR most current presidential authority. Introduced 7/19/85; referred to Finance Committee; no further action.
S 1493 (Heinz + 3)	Comprehensive Trade Law Reform Act (TRAC bill). Strengthen antidumping and countervailing duty provisions and transfer presidential authority to central administrating authority. Introduced 7/25/85; referred to Finance Committee; no further action.
S 1544 (Roth + 17)	Trade Adjustment Assistance Reform Act. Expands worker retraining programs. Merges S 23 and S 234. 7/31/85; referred to Finance Committee; hearings held 9/17/85 by trade subcommittee.
S 1679 (Grassley + 11)	National Security and Trade Act. Introduced 9/20/85; referred to Finance Committee; no further action.
S 1753 (Domenici + 1)	Trade Act of 1974 amendment to eliminate the discretion of the president to grant import relief. Introduced 10/9/85; referred to Finance Committee; no further action.

S 1763 (Heinz + 0)	Export financing program: mixed credits. Introduced 10/10/85; referred to Banking Committee; subcommittee hearing 10/30/85 (43B, 11/8/85).
S 1797 (Hart + 4)	Omnibus trade reform package. Introduced 10/29/85; referred to Finance Committee; no further action.
S 1829 (Riegle + 0)	Establishes trade data bank. Introduced 11/5/85; referred to Governmental Affairs Committee; no further action.
S 1837 (Bentsen + 46)	Senate Democratic trade reform and policy package. Introduced 11/7/85; referred to Finance Committee; no further action (44B, 11/15/85).
S 1860 (Danforth + 35)	Finance Committee omnibus trade reform package. Introduced 11/20/85; referred to Finance Committee; textile amendment by Hollings 12/18/85; no further action (46B, 12/6/85).
S 1861 (Mattingly + 14)	Establishes national trade policy. Introduced 11/20/85; referred to Finance Committee; no further action.
S 1862 (Chafee + 17)	Eliminates barriers to trade. Introduced 11/20/85; referred to Finance Committee; no further action.
S 1863 (Heinz + 12)	Expands Trade Act of 1974 provisions for import relief. Introduced 11/20/85; referred to Finance Committee; no further action.
S 1864 (Mitchell + 14)	Retaliation against foreign targeting practices. Introduced 11/20/85; referred to Finance Committee; no further action.
S 1865 (Baucus + 19)	Trade negotiation authorization. Introduced 11/20/85; referred to Finance Committee; no further action.
S 1866 (Bradley + 14)	Establishment of exchange rate and developing-country debt policy. Introduced 11/20/85; referred to Foreign Relations Committee; no further action.
S 1867 (Dole + 12)	Withdraws preferential treatment from certain developing nations. Introduced 11/20/85; referred to Finance Committee; no further action.
S 1868 (Heinz + 12)	Amends Tariff Act of 1930 to determine dumping by nonmarket-economy countries. Introduced 11/20/85; referred to Finance Committee; no further action.
S 1869 (Lautenberg + 17)	Enhanced protection of intellectual property rights. Introduced 11/20/85; referred to Finance Committee; no further action.
S 1870 (Bingaman + 16)	Export promotion measures. Introduced 11/20/85; referred to Governmental Affairs Committee; no further action.
S 1871 (Grassley + 12)	Strengthens remedies against imports threatening national security. Introduced 11/20/85; referred to Finance Committee; no further action.
S 1934 (Heinz + 0)	Export Trading Company regulations. Introduced 12/12/85; referred to Banking Committee; no further action.
S 1981 (Murkowski + 4)	Provides duty on *surimi*. Introduced 12/18/85; referred to Finance Committee; no further action.
S 1989 (Hawkins + 3)	Seeks to open Japanese markets to U.S. semiconductors and establish fair conditions for trade. Introduced 12/19/85; referred to Finance Committee; no further action.

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FY 1986 Economic Outlook

The Japanese government's economic outlook for FY 1986 (April 1, 1986-March 31, 1987) envisages a 4 percent real growth rate despite the adverse effects of a strong yen. Predictions by private sector economists are less optimistic, falling mainly between 2.5 percent and 3.5 percent. Some observers speculate that the official forecast is merely a policy target designed to avoid political problems at the economic summit in May by showing that Tokyo is serious about stimulating the economy.

According to the Economic Planning Agency, external demand will have a negative effect on growth in FY 1986 for the first time since FY 1978 (see Table 1). The EPA is counting on a significant jump in private consumption and investment to maintain growth near the 4.2 percent rate expected during the current fiscal year. A drop in the inflation rate to below 2 percent, resulting from the stronger yen and declining oil prices, is expected to raise real income and produce a 3.6 percent increase in consumer spending. The EPA also anticipates a 7.5 percent increase in capital spending, on the grounds that expenditures will not be affected by slowing exports. In addition, tax incentives are expected to help raise residential construction by 4.6 percent.

Government economists expect external demand in FY 1986 to offset 0.2 percentage point of domestic demand's projected 4.2 percentage point contribution to inflation-adjusted growth, as the sharp appreciation of the yen slows the pace of exports. This forecast is based on an exchange rate of Y204=$1.00. At the same time, however, the higher value of the yen should keep the current account surplus at the $51 billion level estimated for the current fiscal year.

Private analysts, however, anticipate a smaller increase in private sector spending (see Table 2). Declining corporate earnings, they believe, will slow capital expenditures well below the 11.5 percent increase expected during the current fiscal year and the government's 7.5 percent forecast for FY 1986. Small spring wage increases and semiannual bonuses are expected to restrain the growth in consumer spending to the 3 percent level estimated for this fiscal year. Although current account balance forecasts show a wide range, private sector economists generally agree with the EPA that the surplus will not decline in FY 1986.

Many of the forecasts assume that the government will adopt more stimulative fiscal and monetary policies. The 3.8 percent real economic growth predicted by the Research Institute of the National Economy, for example, assumes that both Japan and the United States will lower their official discount rates and that Tokyo will pursue a more expansionary fiscal policy. If such actions are not taken, the Institute expects growth of only 2 percent in FY 1986. The Nomura Research Institute's 3.3 percent growth rate is based on the assumption that public works spending will be increased by 6.9 percent.

Uncertainties over the strength of the yen and U.S. economic growth also account for the disparity among forecasters. Tokai Bank, which predicts only 2 percent overall real growth, bases its forecast on an average exchange rate of Y187=$1.00 and 2.4 percent economic growth in the United States, leading to a 2.5 percent decline in exports. The Research Institute of the National Economy's more optimistic 3.8 percent, in contrast, assumes an exchange rate of Y209=$1.00 and U.S. growth of 3.1 percent, leading to a 4.2 percent increase in exports.

Randall S. Jones

Table 1: Japanese Government FY 1986 Forecast

(percentage change in real terms)

	Actual			Estimated	Projected
	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986
Gross National Product	3.2%	3.7%	5.0%	4.2%	4.0%
Consumer Spending	4.2	3.1	2.6	3.0	3.6
Residential Construction	1.2	-9.0	0.4	3.1	4.6
Capital Spending	2.0	4.9	10.9	11.5	7.5
Current Account Surplus*	$9.1	$24.2	$37.0	$51.0	$51.0
Trade Surplus*	$20.1	$34.5	$45.6	$58.0	$56.0
Wholesale Prices	1.0	-2.3	0.2	-2.4	-1.8
Consumer Prices	2.4	1.9	2.2	2.1	1.9

*In billions of dollars.

Table 2: Summary of Private Forecasts for FY 1986

(percentage change in real terms)

	GNP	Consumer Spending	Capital Spending	Exports	Current Account Surplus*	Y/$ Exchange Rate
Tokai Bank	2.0%	2.9%	3.8%	-2.5%	$42.0	Y187
Mitsubishi Research Institute	2.1	2.4	1.7	-2.3	58.3	207
Meiji Life Insurance	2.7	2.6	4.4	1.7	52.0	205
Sumitomo Trust Bank	3.0	4.7	4.7	-4.0	43.2	195
Dai-Ichi Kangyo Bank	3.0	3.2	6.3	0.9	58.0	200
Nikko Research Center	3.0	2.7	4.3	-3.8	54.4	200
Bank of Tokyo	3.1	3.4	5.0	-0.5	47.6	198
Japan Economic Research Institute	3.2	3.2	4.1	1.1	63.9	202
Nomura Research Institute	3.3	3.2	4.5	-0.2	52.4	193
Japan Research Institute	3.5	3.7	4.7	3.1	51.2	200
Research Institute of the National Economy	3.8	2.9	5.0	4.2	63.4	209

*In billions of dollars.

The Cabinet's FY 1986 Budget Draft: Mixed Spending . . .

For its last official act, the outgoing cabinet of Prime Minister Yasuhiro Nakasone approved a fiscal 1986 budget that calls for a 3 percent rise in overall spending, a 0.004 percent cut in discretionary spending and a

6.2 percent expansion of the Fiscal Investment and Loan Program, the so-called second budget. Although slightly more generous than the Ministry of Finance's final proposal to the cabinet, it can hardly be called profligate, and analysts predict that the budget's stimulative economic impact will be modest.

Total General Account expenditures are targeted at Y54.1 trillion ($270.4 billion at Y200=$1.00), a fractional improvement over MOF's Y54.03 trillion proposal. Nondiscretionary spending continues to grow at a rapid pace, with debt service costs rising 10.7 percent and transfers to local governments up 5.1 percent. These increases bring the nondiscretionary portion of overall outlays from 37.9 percent in fiscal 1985 to 39.8 percent, reducing the government's fiscal maneuvering room. Nevertheless, Mr. Nakasone's priorities remain clear: to hold discretionary spending in check except for defense outlays and official development assistance (see Table 1). Budget losers and winners are evenly matched when only discretionary categories are considered, but some of the winners were spared the axe only because of demographic or other factors.

The government's selective economizing is clear upon closer examination of the budget. Although spending for science and education was down overall, the reduction fell entirely on funds for school facilities and public education foundations; expenditures for teachers and research and development are slated to grow 0.4 and 4.2 percent, respectively. Spending on pensions, social security and health facilities will rise, while outlays for unemployment insurance and welfare funds will decline. Despite a retroactive pay raise for government workers, the total allotment for government operations will decrease 5.6 percent.

In an effort to bolster the stimulative impact of the public sector, MOF and other ministries have compiled a new five-year construction plan calling for large-scale transportation and water projects, public housing and parks (see Table 2). Although the number of residential units planned has declined from the previous five-year outline, other categories were given more generous treatment. A key aspect of this new plan is to encourage private participation and utilize private sources of capital whenever possible.

Reversing this fiscal year's first-ever decline, the FY 1986 Fiscal Investment and Loan Program will grow Y1.3 trillion ($6.5 billion) to Y22.2 trillion ($111 billion), a 6.2 percent gain. The Nakasone government has hailed this increase as the much-talked-about fiscal stimulus that will reduce the economy's reliance on foreign trade for growth. In contrast to the previous FILP budget that featured almost across-the-board reductions, funding for 33 programs will be increased, 18 will be cut and five initiated in fiscal 1986. Programs concerned with economic infrastructure, such as roads and water works, will receive the largest increases.

With central government spending under such tight restraint, spending by prefectural authorities is receiving increased attention. As a group, localities are planning to increase their budgets by approximately 4.6 percent to a total of about Y5.3 trillion ($26.5 billion). Outlays for wages, grants and other direct payments will jump 6 percent, while funds for public works will rise 2.5 percent (see Table 3).

This hodgepodge of spending increases and cuts casts uncertainty over the public sector's contribution to economic growth for the coming fiscal

Table 1: Japan's General Account Expenditures, FY 1985-FY 1986

(initial budgets in millions of yen)

	FY 1985	FY 1986	Change
Debt Service	Y10,224,158	Y11,319,518	10.7%
Local Government Transfers	9,690,080	10,184,955	5.1
Nondiscretionary	19,918,238	21,504,473	8.0
Social Security	9,576,644	9,834,555	2.7
Public Works	6,368,900	6,222,344	-2.3
Education and Science	4,840,933	4,844,516	0.1
Defense	3,137,148	3,343,549	6.6
Pensions	1,863,689	1,850,139	-0.7
Economic Cooperation	586,387	623,244	6.3
of which: ODA	581,000	622,000	7.0
Energy Measures	628,779	629,680	0.1
Small and Medium Enterprises	216,157	205,218	-5.1
Food Control Account	695,350	596,188	-14.3
Other Operating Expenses	4,324,418	4,083,737	-5.6
Debt Reserves	350,000	350,000	0.0
Discretionary	35,585,405	35,584,170	-0.0
Total	52,499,643	54,088,643	3.0

Table 2: Japan's FY 1986-FY 1990 Construction Plan

(number of houses and billions of yen)

	Requested	Budgeted
Housing	7,700,000	6,770,000
Coastal Works	Y1,160	Y930
Harbors	5,340	4,260
Airports	2,160	1,710
Underground Water Works	14,100	11,800
Repairs to Facilities	2,110	1,760
Parks	3,700	2,880
Highway Safety Improvements	1,350	910

Table 3: Expenditures by Local Governments, FY 1985-FY 1986

(in billions of yen)

	FY 1985	FY 1986	Change
Direct Payments	Y14,958.2	Y15,850.0	6.0%
Debt Service	5,667.7	5,870.0	3.6
Public Works	16,634.3	17,050.0	2.5
Total	50,527.1	52,850.0	4.6

year. Some cuts appear to be damaging, such as those aimed at school facilities, public housing and disaster reconstruction, perhaps offsetting the positive effects of some increases and new projects. It is very clear that Mr. Nakasone and austerity-minded MOF officials remain in control of the fiscal levers, despite mounting domestic and foreign pressure for more spending.

Jon Choy

. . . And Uncertain Revenues

Even though a tight lid has been clamped on spending, Tokyo plans to rely more heavily on tax revenues during fiscal 1986. Prime Minister Yasuhiro Nakasone's pledge to balance the budget is the primary motivation behind this trend. Lower-than-predicted economic growth is likely to upset Mr. Nakasone's applecart, however, leading to reduced tax revenues and pressure for tax increases. A further complication is Tokyo's desire to stimulate domestic demand for domestic and international purposes.

In order to finance the 3 percent increase in overall General Account outlays while reducing the current deficit, the cabinet approved the following general guidelines: increased tax revenues of 5.2 percent to Y40,560 billion ($202.8 billion at Y200=$1.00); an even larger 13.8 percent jump in non-tax revenues of Y2,583 billion ($12.9 billion); and a 6.3 percent reduction in new government bond issues to Y10,946 billion ($54.7 billion). The reality of a slowing economy will force the Finance Ministry to miss its targeted Y1 trillion bond issue reduction, but the Y734 billion ($3.7 billion) cut projected will still be a significant achievement if met.

As is the case in the current fiscal year, most of the increased tax burden will fall on businesses (see Table 1). The fact that corporations experiencing business losses will be asked to pay some taxes is an indication of the severity of fiscal pressures. The same pressures led the Liberal Democratic Party to beat back an opposition party campaign for a personal income-tax cut, as well as scaled-back housing incentives. The government's failure to institute a major new indirect tax is all the more prominent given last year's intense debates over such a tax. A Y1-per-piece increase in the cigarette tax is one of the few indirect tax hikes being considered.

Non-tax revenues received special attention because of the government's commitment to making public corporations pay more of their own way. Japanese consumers could pay more for the following items in fiscal 1986: railway transportation (5 percent, effective October 1986); rice (Y3,867 per 10 kilos after February 1986, versus the current Y3,764 price); tuition fees (Y36,000 per year more than the current Y252,000); and health care (up to Y1,000 per month for outpatient visits and up to Y500 per day for hospital stays).

Prefectural governments have chosen to increase both taxes and debt (see Table 2), reflecting the increased activity expected at the local level. In order to counteract the impact of the tax hikes on businesses, investment incentives are being studied by many local governments.

As always, these projections hinge on how well the economy performs in the coming year -- lower-than-expected growth will mean a revenue shortfall.

This is exactly the position the government is currently facing. With growth expected to slow in the last half of FY 1985 (see JEI Report No. 48B, December 20, 1985), MOF now estimates that revenues will fall below its worst-case projections, igniting a debate on how to make up the difference. This same sequence of events is likely to be repeated in the next fiscal year, particularly in light of the government's optimistic growth forecast (see article in this issue). In any case, it is apparent that Tokyo's fiscal 1986 tax policies will be mildly stimulative at best.

Jon Choy

Table 1: Japan's FY 1986 Tax Changes

(in billions of yen)

	Revenue Gain (Loss)
National Income Tax	
Partial liability for net loss corporations	Y220
Reduced deductions for purchases of particular equipment	30
Tougher regulations for small businesses	20
Increased deduction for home purchases	(30)
Local Taxes	
Increased corporate income-tax rates	22
Increased consumption/investment allowances	(10)
Increased residence tax allowance	(1)

Table 2: Projected Prefectural Revenues, FY 1985-FY 1986

(in billions of yen)

	FY 1985	FY 1986	Change
Local Income Taxes	Y22,519	Y24,072	6.9%
Local Transfer Taxes	462	483	4.6
Local Gift Taxes	9,450	9,831	4.0
Local Bond Issues	3,950	4,429	12.1

Cabinet Approves 6.58 Percent Hike For Defense

The Nakasone cabinet approved a 6.58 percent hike in fiscal 1986's defense budget, launching the first year of the new five-year planning estimate. While the figure is not as high as that sought initially by the Japan Defense Agency, it should be enough to start the program off on the right foot. Japanese observers suggest that annual average spending increases of at least 6 percent will be necessary to fulfill the nation's military goals.

Under the proposed budget, which is expected to encounter no more obstacles in the Diet than in previous years, total defense spending will to nongovernmental aid organizations; and promotional efforts to educate the public about aid.

Sheri Hoptman

Currency Realignment In 1985

In 1985 the yen climbed to its highest value against the dollar since 1981. Although 1985's average exchange rate of Y238.5 was about the same as 1984's, by year-end the yen had appreciated over 28 percent from its low in February (see Table 1). About two-thirds of the yen's rise occurred after the September 22 agreement by the five major industrial countries to lower the value of the dollar.

The monetary policies pursued in Washington and Tokyo have played a major role in the rise of the yen relative to the dollar. U.S. money supply growth last year was considerably over target with an 11.7 percent increase, and interest rates declined. The Bank of Japan, in contrast, restricted money supply growth (M_2+CDs) to 8-9 percent and raised interest rates during the last three months of 1985. These policies have narrowed the interest rate differential between the two countries that had led to capital flows to the United States and a strong dollar. The gap in long-term interest rates fell from about four percentage points in January to two points at the end of the year.

After appreciating 45 percent against the European Currency Unit (a weighted basket of 11 West European currencies) between 1981 and 1984, the yen declined modestly during the first eight months of 1985 (see Table 2). Since the September G-5 agreement, though, Tokyo's tight monetary policy has raised the value of the yen relative to European currencies. In December 1985 the yen was down between 2 to 3 percent from year-earlier levels against the French franc and German mark and up slightly against the British pound. It has also appreciated relative to the currencies of its important Asian trading partners, including China, South Korea and Taiwan.

In late December there were signs that Tokyo planned to ease the tight monetary policy that had boosted the yen at the expense of economic growth. On December 18 Prime Minister Yasuhiro Nakasone called for a cut in interest rates to stimulate domestic demand. Given his commitment to fiscal austerity, the prime minister finds it necessary to rely on monetary policy to encourage growth and fulfill Japan's pledge in the G-5 agreement to improve its domestic economy in preparation for the economic summit in May.

Shortly after the prime minister's statement, Bank of Japan governor Satoshi Sumita said that the bank would gradually move away from its policy of encouraging high interest rates. Short-term rates had risen rapidly following Mr. Sumita's statement in October that the bank intended to guide rates higher. Unconditional call rates, for example, rose from 6.8 percent on October 25 to 8.1 percent on December 17 before falling to 7.4 percent on January 6. On December 28 Japan's long-term credit and trust banks lowered the long-term prime lending rate from 7.5 percent to 7.2 percent. Mr. Sumita said the bank's decision was based on the narrowing of the interest rate differential between Japan and the United States -- a result of the drop in U.S. rates and the firmness of the yen at around the Y200=$1.00 level.

The Bank of Japan is also considering a cut in the official discount rate, the rate at which the central bank lends money to commercial banks. The rate has been set at 5 percent for the past 27 months. Many observers believe that the government's optimistic forecast of 4 percent real growth is premised on a cut in the discount rate and expect it to fall once the Federal Reserve Board lowers the U.S. discount rate.

Randall S. Jones

Table 1: Yen-Dollar Exchange Rate, 1981-85

(monthly average)

	1981	1982	1983	1984	1985
January	Y202.0	Y224.6	Y232.9	Y234.0	Y254.1
February	205.9	235.2	236.3	233.7	260.3
March	208.8	240.7	237.9	225.5	258.4
April	215.1	244.9	237.7	225.0	251.7
May	220.7	236.5	234.8	230.7	251.6
June	224.2	251.0	240.1	233.3	249.0
July	232.0	255.1	240.5	242.7	241.7
August	233.7	258.8	244.4	242.2	237.2
September	230.0	262.7	242.7	245.2	236.9
October	231.4	271.4	233.0	246.9	214.8
November	223.7	265.1	235.3	243.3	203.9
December	218.8	242.5	234.3	248.0	202.8
Annual Average	220.5	249.1	237.5	237.5	238.5

Table 2: Yen-ECU Exchange Rate, 1981-85

(monthly average)

	1981	1982	1983	1984	1985
January	Y259.8	Y239.6	Y224.0	Y188.1	Y178.4
February	248.4	242.9	223.1	194.1	175.9
March	251.8	243.8	223.2	193.9	174.3
April	252.6	244.5	219.9	190.2	182.5
May	244.3	244.4	215.7	187.9	181.2
June	239.0	245.5	214.3	190.3	182.5
July	239.8	244.5	211.4	190.7	186.5
August	235.3	246.4	208.3	187.9	189.3
September	243.1	247.3	206.7	181.8	186.0
October	251.3	252.5	201.8	179.8	n.a.
November	245.7	242.7	198.5	181.5	n.a.
December	237.1	231.5	192.6	178.5	n.a.
Annual Average	245.7	243.8	211.6	187.1	n.a.

Special Diet Session Concludes; Cabinet Reshuffled

The special session of the Diet concluded December 21 without taking action on the centerpiece of the session: court-ordered legislation to align lower house election districts to provide equality in voter representation. The Diet's failure to enact the "6-6" bill, which would have shifted six lower house seats from over-represented districts to comparably under-represented districts, was a significant setback for Prime Minister Yasuhiro Nakasone, who pinned much of his political future on the legislation.

Since Japan's courts ruled that the 1983 lower house elections violated voters' rights to equality of representation because of vast disparities in relative voting strength among electoral districts, the ruling Liberal Democratic Party has been under pressure to enact some form of electoral district reform legislation. Most observers agree that, official protestations notwithstanding, a lower house election could be ruled null and void unless such reforms are passed. For Mr. Nakasone, this is particularly critical. Lower house elections could be a key element in his retaining the LDP presidency -- a demonstration of his overwhelming popularity among voters and party members, and a justification for a third term.

Opposition to the 6-6 bill, however, has been so severe as to cast doubt on the likelihood of its approval even in the next regular session of the Diet. Opposition parties are concerned that the reform bill would in fact strengthen the LDP's hold on the lower house by eliminating the third seat from several multi-member districts -- the slots often captured by opposition parties -- and shift them to districts where LDP strength is sufficient to win additional seats or at least maintain the party's relative strength against challengers. Members of the LDP factions affected by the proposed changes balked, particularly in Toshio Komoto's fading faction, already facing difficulties because of the financial problems arising from the bankruptcy of the company he once headed. Finally, Mr. Nakasone's opponents within the LDP reportedly were cool to the legislation in order to weaken his position in the party and speed his retirement.

The Diet was able to enact legislation implementing key sections of last July's "action program" as well as a measure restructuring the country's pension system. Most eyes were on the electoral reform bill, however, and the consensus among political observers in Japan was that its demise was a major failure for the Nakasone government.

Shortly after the session concluded, the prime minister reshuffled his cabinet, retaining Foreign Minister Shintaro Abe, Finance Minister Noboru Takeshita and Japan Defense Agency director general Koichi Kato. New faces appeared in the Ministries of Education, International Trade and Industry, and Posts and Telecommunications. Cabinet secretary Takao Fujinami was replaced by Masaharu Gotoda, and Masumi Esaki, a prominent member of the high-level delegation led by Susumu Nikaido to the United States last fall, will head the agency responsible for coordination with the United States on trade issues.

The cabinet changes mirrored several political and policy realities. The first is clearly the emphasis on continuity in government policies -- including fiscal austerity -- despite calls for stimulative actions to reduce trade frictions with major trading partners. This is reflected in the decision to retain the ministers responsible for foreign relations, the role of the yen in international markets, and the country's self-defense policies.

Retaining the previous factional alignment in the new cabinet indicates one of two possibilities. The first is that policy continuity is so important to the prime minister that he did not want to risk creating internal opposition to his policies by attempting to tilt the balance of power within the cabinet to his side. The second is that he simply lacks the political power to risk such a maneuver. While opposition to his remaining in office beyond December 1986 has strengthened, at this point it seems fair to assume that the former consideration was more important in the cabinet choices than the latter, although Mr. Nakasone and his supporters certainly did not want to precipitate a confrontation at this point.

Michael W. Chinworth

Fourth Nakasone Cabinet

December 28, 1985

Ministry	Name	Age	Faction
Prime Minister	Yasuhiro Nakasone*	67	Nakasone
Justice	Seigo Suzuki	74	Fukuda
Foreign Affairs	Shintaro Abe*	61	Fukuda
Finance	Noboru Takeshita*	61	Tanaka
Education	Toshiki Kaifu	54	Komoto
Health and Welfare	Isamu Imai	66	Suzuki
Agriculture, Forestry, Fisheries	Tsutomu Hato	50	Tanaka
International Trade and Industry	Watanabe Michio	62	Nakasone
Transportation	Hiroshi Mitsuzuka	58	Fukuda
Posts/Telecommunications	Bunsei Sato	66	Nakasone
Labor	Yu Hayashi	61	Suzuki
Construction	Takami Eto	60	Nakasone
Home Affairs	Ichiro Ozawa	43	Tanaka
State Ministers			
Cabinet Secretary	Masaharu Gotoda	71	Tanaka
Management/Coordination	Masumi Esaki	70	Tanaka
Hokkaido/Okinawa Development	Raishiro Koga	70	Tanaka
Defense	Koichi Kato*	46	Suzuki
Economic Planning	Wataru Haraizumi	56	Suzuki
Science/Technology	Yohei Kono	48	NLC
Environment	Yoshihide Mori	66	Komoto
National Lands	Heihachiro Yamazaki	74	Fukuda
Legislative Director	Takashi Moguchi*	65	--
Liberal Democratic Party Positions			
President	Yasuhiro Nakasone*	67	Nakasone
Vice President	Susmu Nikaido*	76	Tanaka
Secretary General	Shin Kanemaru*	71	Tanaka
Chairman, Executive Council	Kiichi Miyazawa*	66	Suzuki
Chairman, Policy Affairs Research	Masayuki Fujio*	68	Fukuda

*Retained from previous cabinet.

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OUTLOOK FOR THE JAPANESE ECONOMY IN FY 1986

Summary

Japan's current economic expansion, which began in March 1983, has now lasted longer than the average of 25 months in recent years. Strong economic growth, initiated by exports and supplemented by capital investment, has increased per-capita gross domestic product to over $10,000, the ninth-largest in the world. The government forecasts continued strong economic growth of 4 percent in real terms in FY 1986. Private sector economists, however, are unanimous in predicting slower growth and many believe the economy has reached a turning point.

Real growth in FY 1986, which should be about 3 percent, will result entirely from an expansion of domestic rather than external demand, due to the appreciation of the yen. While low inflation of less than 2 percent will encourage personal consumption, falling corporate income will lower wage increases, restraining the rise in personal consumption. Smaller profits will also curb business investment. Government fiscal policy should have a modest stimulative effect, however.

The Government Forecast

Despite the adverse effects of a strong yen, the Japanese government's economic outlook for FY 1986 (April 1, 1986-March 31, 1987) envisages a 4 percent real growth rate. According to the Economic Planning Agency, external demand will have a negative effect on growth for the first time since

FY 1978. Net exports have played an important role in the current expansion, accounting for one-fourth of the 18 percent increase in real gross national product. Now, however, the EPA is counting on a significant jump in domestic demand to maintain growth near the 4.2 percent rate expected during the current fiscal year (see Table 1).

Forecasts from 11 major Japanese banks and research institutions for FY 1986 range from 2 percent inflation-adjusted growth to 3.8 percent (see Table 2). The average prediction of a 3 percent increase represents the lowest rate since FY 1974 when the first oil crisis led to no growth. Many of the forecasts assume that the government will adopt more stimulative fiscal and monetary policies. The 3.8 percent rate projected by the Research Institute of the National Economy, for example, assumes that both Japan and the United States will lower their official discount rates and that Tokyo will pursue a more expansionary fiscal policy. Absent such actions, the institute puts growth at only 2 percent.

The government forecast is surprising in light of the November EPA report noting a slowdown in the expansion and EPA director-general Ippei Kaneko's early December statement that 4 percent growth would be hard to attain. Some observers speculate that the official figure is merely a policy target based on political considerations. With the May summit approaching, the government is anxious to demonstrate that it is serious about fulfilling its commitment to stimulate domestic demand.

External Demand

Government economists expect external demand in FY 1986 to offset 0.2 percentage point of domestic demand's projected 4.2 percentage point contribution to inflation-adjusted growth. EPA forecasters say that the current account surplus will stay at FY 1985's estimated $51 billion level and the trade surplus will fall by $2 billion to $56 billion, while private predictions of the FY 1986 current account surplus range from $42 billion to $64 billion. Export forecasts range from Sumitomo Trust & Banking Co., Ltd.'s 4 percent contraction to the Research Institute for National Economy's 4.2 percent rise.

One reason for the wide disparity is differing assumptions on the strength of the yen and the rate of U.S. economic growth. Tokai Bank, Ltd., which predicts only 2 percent overall real growth, bases its forecast on an average exchange rate of Y187=$1.00 and 2.4 percent economic growth in the United States, leading to a 2.5 percent decline in exports. The Research Institute of the National Economy's more optimistic 3.8 percent growth projection, in contrast, assumes an exchange rate of Y209=$1.00 and U.S. expansion of 3.1 percent, translating into a 4.2 percent increase in exports.

Any forecast of the Japanese economy depends heavily on both these factors, which are detailed below.

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Table 1: Japanese Government FY 1986 Forecast

(percentage change in real terms)

	Actual			Estimated	Projected
	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986
Gross National Product	3.2%	3.7%	5.0%	4.2%	4.0%
Consumer Spending	4.2	3.1	2.6	3.0	3.6
Residential Construction	1.2	-9.0	0.4	3.1	4.6
Capital Spending	2.0	4.9	10.9	11.5	7.5
Current Account Surplus*	$9.1	$24.2	$37.0	$51.0	$51.0
Trade Surplus*	$20.1	$34.5	$45.6	$58.0	$56.0
Wholesale Prices	1.0	-2.3	0.2	-2.4	-1.8
Consumer Prices	2.4	1.9	2.2	2.1	1.9

*in billions of dollars

Source: Economic Planning Agency

Table 2: Summary of Private Forecasts for FY 1986

(percentage change in real terms)

	GNP	Consumer Spending	Capital Spending	Exports	Current Account Surplus*	Y/$ Exchange Rate
Tokai Bank, Ltd.	2.0%	2.9%	3.8%	-2.5%	$42.0	Y187
Mitsubishi Research Institute	2.1	2.4	1.7	-2.3	58.3	207
Meiji Life Insurance Co., Ltd.	2.7	2.6	4.4	1.7	52.0	205
Sumitomo Trust & Banking Co., Ltd.	3.0	4.7	4.7	-4.0	43.2	195
Dai-Ichi Kangyo Bank, Ltd.	3.0	3.2	6.3	0.9	58.0	200
Nikko Research Center	3.0	2.7	4.3	-3.8	54.4	200
Bank of Tokyo, Ltd.	3.1	3.4	5.0	-0.5	47.6	198
Japan Economic Research Institute	3.2	3.2	4.1	1.1	63.9	202
Nomura Research Institute	3.3	3.2	4.5	-0.2	52.4	193
Japan Research Institute	3.5	3.7	4.7	3.1	51.2	200
Research Institute of the National Economy	3.8	2.9	5.0	4.2	63.4	209

*in billions of dollars

Source: Japan Economic Journal, December 23, 1985, p.4

Outlook For The Yen - In 1985 the yen climbed to its highest value against the dollar since 1981. By year-end, it had appreciated over 28 percent from its February low, with about two-thirds of this increase following the September 22 G-5 agreement to lower the value of the dollar. Intervention in exchange markets and a hike in short-term interest rates encouraged the appreciation of the yen.

There have been signs that Tokyo plans to ease the tight monetary policy that has boosted the yen at the expense of economic growth. On December 18, Bank of Japan governor Satoshi Sumita announced that the bank would gradually move away from its policy of raising short-term interest rates. Mr. Sumita said the bank's decision was based on the narrowing of the interest rate differential between Japan and the United States and the firmness of the yen at around Y200=$1.00.

The EPA forecast of an average exchange rate of Y204=$1.00 appears to be an appropriate assumption. Tokyo is unlikely to take policy steps that would undermine the appreciation of the yen -- an appreciation that has been effective in dampening protectionist pressures in the Congress. Although anxious to stimulate domestic demand through lower interest rates, the central bank is said to be waiting for a fall in the U.S. discount rate before cutting its own for fear that another widening of the interest rate gap would lower the value of the yen. The government appears satisfied with a rate around Y200=$1.00 but any rise in the yen above that mark would probably be offset by a decline in Japanese interest rates.

U.S. Economic Outlook - The pace of economic growth in the United States, which buys more than one-third of Japanese exports, played a major role in Japan's strong expansion in 1984 as well as in the 1985 slowdown. In FY 1984 the increase in net exports to the United States exceeded the total rise in net exports, which in turn was responsible for one-fourth of Japan's economic growth in that year. If the associated increase in investment is included, the United States was responsible for well over one-fourth of Japanese growth in the April 1984-March 1985 period.

The United States is entering the fourth year of economic expansion, a span far longer than the average of 27 months achieved in 25 peacetime cycles. The upturn since late 1982, a result of the successful anti-inflation program initiated by the Federal Reserve Board in November 1979 and stimulative government fiscal and monetary policies, can be divided into two distinct periods. During the first 18 months, real GNP growth averaged 7 percent, but from mid-1984 through 1985, output gains averaged only 2.3 percent.

Debt-service problems stemming from the large accumulation of public and private debt will eventually restrict consumption and investment, slowing economic activity. Consumers have a total debt of over $2 trillion, business has added $350 billion of debt during the past two years, and the national debt has risen from $930 billion in 1980 to $1.8 trillion. But given the fiscal and monetary stimulus already in place, a recession during 1986 is unlikely. Monetary policies are likely to remain accommodative until fundamental GNP and inflation signals change. The Gramm-Rudman-Hollings legislation, designed to eliminate the government budget deficit by 1991, mandates only $12 billion in spending cuts during 1986, and expectations of falling deficits have encouraged a drop in long-term interest rates to their lowest level since 1979.

The U.S. economy is likely to grow about 3 percent in real terms in 1986. Consumer spending should continue to be strong, with inflation moderate and interest rates lower. Personal income will increase as employment rises and individual portfolios reflect rising stock and bond prices. Given the fall in the personal saving rate from its 7 percent average of the past 10 years to 3.5 percent in the third quarter of last year, some observers expect consumption to decline as consumers attempt to return to normal conditions. It is likely, however, that consumers now consider the increasing value of their financial assets and durable goods to be substitutes for traditional savings. Furthermore, the debt and saving figures reflect demographic changes that have increased the number of people in the 25- to 44-year-old age bracket.

Although changes in inventories and net exports of goods and services are only a small component of total GNP, the volatility of these factors gives them a direct impact on the cyclical pattern. The liquidation of inventory stocks in 1985 was a major factor in holding down the overall growth rate just as the rapid accumulation of inventories in 1983 and 1984 was a crucial element in the economic recovery. Given the low inventories-to-sales ratios in most sectors, it is likely that stocks will have to be replenished in 1986. Net exports should also begin to contribute to GNP later this year, as the sharp 25 percent drop in the trade-weighted value of the U.S. dollar against other major industrial currencies since February 1985 eventually reverses the deteriorating trade balance.

The major threat to continued U.S. economic growth is renewed inflation resulting from both the unusually rapid growth of money and credit and rising import prices. But moderate wage settlements and productivity gains should restrain unit labor costs and contain inflation. Furthermore, declining oil and other commodity prices and intense international competition will promote price stability.

Net Exports - Some of the optimistic forecasts of Japan's export growth are based on its performance in the 1979-80 period following the appreciation of the yen. With the yen at Y175=$1.00 in October 1978, exports rose 12.8 percent in real terms in FY 1979 and 16.6 percent in FY 1980. Rapid growth and high inflation in the United States and other industrialized countries enabled Japanese exporters to raise prices by the full amount of the yen's appreciation without sacrificing export volume.

With today's drastically different international environment, however, the effect of the yen's appreciation is likely to be different. The rise in the yen comes at a time when exports are already slowing due to sluggish growth overseas (see Table 3). The moderate pace of inflation makes it difficult to raise prices by the full appreciation of the yen. In 1979 Japanese auto makers raised their U.S. prices 15 percent, but in today's competitive compact car market, such a price rise would reduce the share of Japanese makes. Moreover, competitors in many industries in Taiwan, Hong Kong and Korea stand ready to benefit from higher prices for Japanese goods. Japanese exporters, therefore, will likely raise prices only one-third to one-half the amount of yen appreciation, and concentrate on reducing production costs and moving to upscale products.

In October 1985 Japan's export volume was up 2.5 percent from a year earlier. Exports rose 7.5 percent in dollar terms but fell 3.2 percent in yen

Table 3: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1983	FY 1984	October-December 1984	January-March 1985	April-June 1985	July-September 1985
Gross National Product	Y267,782.0 (3.7%)	Y281,102.2 (5.0%)	Y284,215.8 (8.9%)	Y285,425.7 (1.7%)	Y289,447.6 (5.8%)	Y291,298.9 (2.6%)
Personal Consumption Spending	155,008.7 (3.1%)	159,100.7 (2.6%)	159,240.9 (2.2%)	161,106.4 (4.8%)	161,900.4 (2.0%)	162,753.3 (2.1%)
Private Residential Construction	13,635.6 (-9.0%)	13,688.4 (0.4%)	13,742.5 (3.5%)	13,913.9 (5.1%)	14,227.9 (9.3%)	13,892.6 (-9.1%)
Private Fixed Nonresidential Investment	42,672.2 (4.9%)	47,342.6 (10.9%)	48,452.9 (17.1%)	48,574.5 (1.0%)	51,124.5 (22.7%)	52,770.0 (13.5%)
Change in Business Inventories	988.8 (-16.9%)	1,839.1 (86.0%)	1,950.7 (-1.3%)	2,112.0 (37.4%)	1,825.3 (-44.2%)	1,384.0 (-66.9%)
Government Current Expenditures	26,050.2 (3.5%)	26,654.9 (2.3%)	26,675.0 (2.1%)	26,979.1 (4.6%)	27,081.5 (1.5%)	27,190.4 (1.6%)
Government Fixed Investment	22,848.1 (-2.2%)	22,159.9 (-3.0%)	22,014.9 (-8.5%)	21,615.5 (-7.1%)	19,954.0 (-27.4%)	20,456.1 (10.5%)
Change in Government Inventories	-227.9 (*)	159.1 (*)	42.6 (*)	27.9 (*)	77.6 (*)	515.6 (*)
Net External Sector	6,806.2 (135.8%)	10,157.3 (49.2%)	12,096.4 (408.5%)	11,096.4 (-29.2%)	13,256.4 (103.7%)	12,336.9 (-25.0%)
Exports of Goods and Services and Factor Income Received	46,313.9 (8.7%)	53,609.8 (15.8%)	55,256.5 (20.9%)	54,833.7 (-3.0%)	57,176.9 (18.2%)	55,149.3 (-13.4%)
Imports of Goods and Services and Factor Income Paid	39,507.7 (-0.5%)	43,452.4 (10.0%)	43,160.1 (-12.6%)	43,737.3 (5.5%)	43,920.5 (1.7%)	42,812.4 (-9.7%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

terms, reflecting the higher yen. The rise in volume despite the yen's appreciation reflects the long lag between the placement of orders and the negotiation of new contracts. Later in 1986 the effect of the stronger yen should begin to be reflected in falling export volumes, further reducing the value of exports in yen terms. But with U.S. growth at around 3 percent and the yen hovering around Y200=$1.00, the decline should not exceed 4 percent.

Assuming import demand is responsive to price changes, the appreciation of the yen should boost imports. But demand for agricultural and industrial raw materials, which account for almost three-fourths of Japanese imports, is relatively insensitive to price changes. The decline in oil prices, which still account for more than a quarter of total purchases, will also lower Japan's import bill. Furthermore, slower growth will restrain demand for foreign goods. In sum, there should be a small decline in imports in FY 1986.

On balance, therefore, the external sector should have a small negative effect on growth in FY 1986. The current account surplus denominated in dollars, though, should rise by several billion dollars from the $52 billion forecast for the current year. With Japan now the largest creditor nation, a declining deficit in the services account will encourage the higher surplus.

Domestic Private Demand

The EPA projection calls for private domestic demand to provide 3.5 percentage points of its 4 percent growth forecast for FY 1986. Detailed analyses of the outlook for personal consumption, residential construction and business investment follow:

Personal Consumption Spending - The government expects the growth of personal consumption spending, which accounts for almost 60 percent of GNP, to accelerate from 3 percent during the current fiscal year to 3.6 percent during FY 1986. The EPA is counting on falling oil prices and the stronger yen to hold the increase in the consumer price index to below 2 percent. Inflation is well under control, as shown by the tenth consecutive monthly decline in the wholesale price index in December. After three consecutive yearly talks, producer prices are now 3.4 percent less than in 1980. Lower inflation, in turn, will increase consumers' real income gains and raise consumption expenditures.

The anticipated increase in consumption resulting from last spring's 5 percent wage increase and a 6 percent rise in the summer bonus has thus far failed to materialize: the actual increase in worker's income has been less than expected due to a decline in overtime. Consumer spending in real terms increased at a modest 2 percent rate in the first half of the current fiscal year.

Achievement of the government's consumption target requires healthy wage and bonus increases this year. But with the slowing in export growth, there will also be less overtime work. Moreover, given the decline in corporate earnings in the current fiscal year, the gains in workers' income are likely to be modest. The winter bonus was only 4.4 percent higher than 1984's, and Nomura Research Institute predicts that the wage increase this spring will be only 4.5 percent. These figures imply real income gains of around 2.5 percent to 3 percent, making the government's 3.6 percent target for consumption spending appear too optimistic.

Daiwa Securities Co., Ltd. forecasts that an oil price decline of $5 per barrel will boost corporate profits 5.2 percent and raise GNP one-quarter of a percentage point. While a decline in oil prices will certainly help, its impact will be muted by Japan's great success in reducing its dependence on oil. Oil imports fell from nearly 5 million barrels a day in 1973 to 3.7 million barrels in 1984. Oil now accounts for less than one-third of the country's imports and its consumption of imported energy is now under 5 percent of GNP -- less than the rates for West Germany, France, Britain and Italy.

Private Residential Construction - Investment in housing construction accounts for less than 5 percent of GNP but has a significant impact on the rate of growth. Housing investment increases overall production by 2.2 times the original investment, compared to only 1.7 times for household consumption. The volatility of residential construction, which has been negative in three of the past five fiscal years, makes it a significant factor in determining overall growth. The decline in housing investment in FY 1983, for example, lowered economic growth by 1.1 percentage point.

Increased residential construction has received political support, both in Japan and abroad, as a way of reducing Japan's huge trade surplus. Many observers suggest that the quality of the housing stock in Japan, where units are on average 31 percent smaller than in the United States, should be improved. Expanded housing investment would absorb the household sector's surplus savings and reduce capital outflows, raising the value of the yen and leading to more imports and fewer exports.

The government hopes that tax incentives will help increase residential construction to its FY 1986 target of 4.6 percent growth. There are tentative plans to grant a tax credit to new homeowners who have borrowed from the government's Housing Loan Corp. Price trends should also encourage housing investment. Increases in the price of land are expected to remain moderate, while the cost of building materials fell in 1985 and the interest rate charged by city banks on housing loans is now at a low 7.7 percent.

Housing investment was sluggish in the first half of FY 1985, although housing starts last fall increased above year-earlier levels. The EPA estimates that housing investment will rise by 3.1 percent in real terms during the current fiscal year, which would be the biggest gain since FY 1978. But unless there is a sharp increase in demand, housing investment in FY 1986 is unlikely to reach the government's target.

During the past 20 years, Japan has built 26.6 million residential units and its housing stock of 38.7 million units exceeds the nation's 35.3 million households. Japan's population is now growing at only a 0.7 percent annual rate and there were only 760,000 marriages in 1983 compared to more than one million each year in the early 1970s. Furthermore, the era of heavy migration to urban areas has ended and the decline in average family size from 4.97 in 1955 to 3.33 in 1980 has reduced the incentive to acquire more spacious housing.

Although housing is more affordable, as shown by the decline since 1980 in the ratio of housing prices to worker's average annual income, buyers cannot count on large annual wage increases to make mortgage payments progressively easier. Furthermore, speculative purchases today are directed more at financial assets than real estate. Investment in houses and land was encouraged in the 1970s by the fact that real estate prices rose more rapidly than wages and inflation. Since 1981, however, the increase in housing and land prices has been less than the inflation rate and the rise in wages.

Although the number of housing starts, which fell from a peak of 1.86 million units in FY 1972 to 1.14 million in FY 1983, has been rising in the past two years, the increase in the value of investment has lagged for several reasons. First, greater use of prefabricated components has lowered construction costs. Second, a larger proportion of new construction is in rental housing, which requires less investment per unit. Several supply-side factors also continue to constrain residential construction. Construction firms complain that such units are no longer profitable as builders are required to bear the rising financial burden of building roads, schools and other public facilities. Then, too, local government regulations have become so rigid as to discourage residential construction.

Private Plant and Equipment Investment - Business investment has been a leading sector in the current expansion, increasing 10.9 percent in FY 1984 and an estimated 11.5 percent in FY 1985 (although the current fiscal year figure is exaggerated by the inclusion of Nippon Telegraph and Telephone Corp. and the tobacco monopoly, Japan Tobacco Inc., which were both privatized last April). Despite slowing exports, the EPA expects business investment, which accounts for about 16 percent of GNP, to grow 7.5 percent in real terms in FY 1986. Most private sector forecasts fall in the 4 percent to 5 percent range.

After setting records in FY 1984, corporate profits are expected to decline by about 5 percent this fiscal year as a result of a slowdown in the electronics industry, which accounts for about 25 percent of corporate earnings, and the rise in the yen. While the stronger currency benefits those industries such as utilities that depend on imports of raw materials, it has cut into the profits of exporters, which have generally limited price hikes to 5 percent to 10 percent. This decline in earnings has slowed the increase in investment spending from 13.4 percent in the first half of FY 1985 to 3.5 percent in the second, according to an EPA survey.

Large corporations are likely to take a long-term perspective in making capital investment decisions, as they remain concerned about their future competitiveness. Business investment should therefore continue to grow in FY 1986, though at a slower pace of about 5 percent to 6 percent.

Government Economic Policies

The draft budgets for FY 1986, which will probably be adopted intact by the Diet, attempt to accommodate two contradictory demands. As part of the government's goal to end reliance on debt-financing bonds, discretionary expenditures are to be cut for the fourth consecutive year. In response to pressure from business circles to stimulate domestic demand, however, the Fiscal Investment and Loan Program (FILP) is projected to increase 6.2 percent and several tax breaks are expected to be introduced.

The general account budget (discretionary expenditures plus debt financing and transfers to local government) is set to rise 3 percent in nominal terms to Y54.1 trillion ($270.4 billion at Y200=$1.00), an increase below last years's 3.7 percent rise. Spending on public works, a major source of pump priming, is to be cut 2.3 percent, while debt service costs and transfers to local governments will rise 10.7 percent and 5.1 percent, respectively (see JEI Report No. 1B, January 10, 1986).

Reversing this fiscal year's decline, the FILP budget, which is financed largely by revenues from the postal savings system, will increase to Y22.2 trillion ($111 billion). Programs concerned with economic infrastructure, such as roads and water works, will receive the largest increases. In addition, outlays by prefectural governments are expected to increase 4.6 percent to Y52.9 trillion ($264.3 billion).

Minor tax reforms are expected to generate Y240 billion ($1.2 billion) more in tax revenues in FY 1986, primarily from the business sector. This increase, as well as the planned continuation of a 1.3 percent tax surcharge on corporate incomes, has brought complaints from business leaders, who claim that business taxes in Japan are higher than in Europe or the United States. Tax breaks for housing as well as plant and equipment investment are also planned.

Tax revenues, which are expected to increase in line with the government's projected 5.1 percent nominal growth rate, and non-tax revenues will total only an estimated Y43.2 trillion ($216 billion), requiring new government bond issues of Y10.9 trillion ($54.7 billion). This represents a Y734 billion ($3.7 billion) reduction from FY 1985's debt financing requirement, but falls short of the government's goal of a Y1 trillion ($5 billion) reduction each year in order to stop issuing deficit-financing bonds by FY 1990.

With the tax breaks planned and the projected increase in spending, fiscal policy in FY 1986 should have a positive effect on the economy, in contrast to the current fiscal year. But its impact will be small, probably around 0.5 to 0.7 percentage point in real terms. Many observers are disappointed with the small fiscal stimulus planned and believe that continued fiscal austerity in the face of the strong yen will slow growth and tax revenues, making it impossible to achieve the goal of fiscal stability. Fiscal policy, they say, should be more expansionary to absorb the excess savings of the household sector.

But the seriousness of the government's fiscal situation is illustrated by the rise in debt service costs to an all-time high of more than 20 percent of the general account budget. The Finance Ministry plans to issue a total of Y22.44 trillion ($112.2 billion) worth of bonds in FY 1986, with Y11.49 trillion ($57.5 billion) intended to refinance bonds falling due during the year. By the end of FY 1986, the outstanding balance of government bonds will total Y143 trillion ($715 billion).

Japan's public debt burden is large compared to other industrialized countries (see Table 4). The percentage of bond issues in total revenues, the ratio of outstanding long-term debt to GNP, per-capita outstanding long-term debt, and interest payments as a share of the total budget are all higher in Japan than in the other G-5 countries. Yet the future social security burden in Japan, whose population will have aged more by the year 2000 than any other country's, make the tight fiscal policies of the Nakasone government more understandable.

Table 4: International Comparison of Fiscal Situations

	Percentage of Bond Issues in Total Revenues	Ratio of Outstanding Long-Term Government Debt to GNP	Per-Capita Outstanding Long-Term Government Debt	Interest Payment/Total Budget Spending
Japan	22.2% (FY 1985)	48.4% (FY 1985)	Y1,260,000 (FY 1985)	18.8% (FY 1985)
United States	19.4 (FY 1985)	33.8 (FY 1984)	1,200,000 (FY 1983)	14.4 (FY 1985)
Britain	5.2 (FY 1984)	43.6 (FY 1982)	960,000 (FY 1982)	6.6 (FY 1984)
West Germany	9.8 (FY 1985)	19.6 (FY 1983)	520,000 (FY 1983)	11.4 (FY 1985)
France	14.0 (FY 1985)	5.3 (FY 1980)	160,000 (FY 1980)	8.4 (FY 1985)

Source: Keidanren Review, No. 95, October 1985

Japan's monetary policy in 1985 has been constrained by exchange rate considerations. Money supply growth has been restrained and the official discount rate has remained at 5 percent. The government and the Liberal Democratic Party agreed in late December to pursue a more flexible monetary policy to stimulate domestic demand, and that is thought to include a cut in the discount rate. Monetary policy, though, is likely to continue to be linked to exchange rate considerations.

Conclusion

Japan's real economic growth in FY 1986 should be about 3 percent, with the private sector contributing about 2.5 percentage points, government 0.5 to 0.7 point and the external sector exerting a small drag. The overall effect of the yen appreciation should be negative, slowing growth from the 4 percent to 5 percent range of the past two fiscal years.

A contrasting opinion is held by the EPA, however. The example of the United States indicates that an appreciating currency need not lead to slower economic growth. Rapid U.S. growth was accompanied by a 60 percent rise since 1980 in the trade-weighted value of the dollar. But an obvious difference in the two cases is that the appreciation of the dollar was, in large measure, the result of an expansionary fiscal policy that encouraged growth. In Japan, the appreciation of the yen has been encouraged by higher interest rates that have discouraged growth. Given Tokyo's fiscal situation and the need to raise the value of the yen in order to reduce protectionist pressures, monetary policy was the logical policy choice to drive up the yen. Large U.S. budget deficits have forced Japan and other countries to run tighter monetary policies than they would otherwise pursue in order to defend their currencies.

Reflecting the view that business expansions die of old age, some observers note that the current Japanese slowdown reflects the maturing of the economy and that a turning point should be expected. This does not appear to be true in the United States, where the probability of the onset of a recession is only weakly related to the age of the expansion. Instead, recessions have been associated with prior outbreaks of inflation, as public policy responses to rising prices have put downward pressure on output and employment.

The swings in the Japanese economy since 1975 have largely been a result of changes in exports, as dependence on external demand has made the country vulnerable to changes in economies abroad, particularly the United States'. If Japan is able to return to growth based primarily on domestic demand, it should be able to enjoy a period of steady expansion, since inflation seems to be well under control.

For further information, contact Randall S. Jones.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japane Economic Institute.

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G-5 Finance Ministers Back Lower Interest Rates

Although the finance ministers of the five leading industrialized nations agreed they would like to see interest rates decline, they stopped short of launching a coordinated international effort to achieve that goal at the Group of Five meeting in London January 18-19. A U.S. Treasury official said that the central banks in the G-5 -- the United States, West Germany, Japan, Britain and France -- would "maintain close contact" on the issue.

On the table was Prime Minister Yasuhiro Nakasone's proposal for a coordinated effort to lower interest rates. The proposal, which was endorsed by France, became a subject of controversy prior to the meeting when the United States denied a West German official's statement that Washington would push for an agreement on lower interest rates. With inflation expected to remain under

Mr. Olmer went on to say that unfair trading practices make up only a marginal portion of the U.S. trade deficit; rather, a variety of factors, including the high value of the dollar and the loss of markets in the debt-ridden developing world, are to blame. A "mix of solutions," as proposed by the administration's trade policy, seems the "right tack," according to the former Commerce official.

He indicated, however, that questions remain about whether the administration's approach will be enough to turn around the deficit -- or even if U.S. trading partners will cooperate with the plans to do so. The consequences of such a failure would be profound, Mr. Olmer warned, stating that "American industry will find itself in a hole so deep that subsequent government intervention to salvage its baldy damaged remnants may take the form of highly protectionist (and politically irresistible) trade legislation. And this would be neither in America's interests nor the world's."

Although he also applauded the policy initiatives taken by the Reagan administration last fall, trade commentator Kevin Phillips outlined in detail further steps to be taken to energize a policy he described as lacking "orderly strategizing." According to Mr. Phillips, if the United States is to be competitive, the administration will have to reconcile playing an active role in economic matters as well as pursue consistent, "high-level strategic coordination of U.S. economic policies." It must also enact a sweeping "competitiveness agenda" of economic reforms that coordinates domestic and international policies, he said, and overhaul the tax system with a value-added tax on imports.

Howard Samuel of the AFL-CIO agreed on the need for an industrial strategy or a "competitiveness framework" and urged that the United States "abandon Adam Smith and adopt Clausewitz' On War" regarding international competition. Raymond Vernon of the Harvard Business School voiced his concern that government and business leaders discussing competitiveness questions fail to consider the implications of growing multinational business activities. Discussions of the benefits and drawbacks of a value-added tax and the scope of structural adjustment programs closed out the session, with indications from the panelists that the debate over the agenda for action, despite the acknowledged air of crisis, is only in its preliminary stages.

Sheri Hortman

Japan's Car Export Limits: The Guessing Game Starts Again

The fifth year of restraints on shipments of Japanese-made cars to the United States still has more than two months to run, but trans-Pacific sparring over the future of the export limits is already in full swing. The current version of what has become an annual ritual started in mid-December when an unidentified Ministry of International Trade and Industry spokesman was widely quoted as telling a Japanese press briefing that Tokyo intended to allow the restrictions on U.S.-bound car exports to expire as planned March 31. Government officials ranging from Prime Minister Yasuhiro Nakasone to the number-two man in MITI's automotive division tried to shoot down this prematurely launched trial balloon, maintaining that no decision had been reached on the quota issue. Their efforts were fruitless. Thirteen auto-state senators fired off letters to the prime minister and new MITI Minister Michio Watanabe warning that an end to the restraints would "further exacerbate our already tenuous trade relationship." Ford Motor Co. and Chrysler Corp. also weighed in with a predictable blast.

While the political fallout in Washington from the huge bilateral trade imbalance might once again dictate another year of limits on Japanese car exports, the economic rationale for continued restraints is missing. U.S. sales of domestic nameplates expanded in 1985 for the third straight year and topped the 8 million mark for the first time since 1979. Sales of Japanese-made cars admittedly increased by a bigger margin as a hike in the shipment ceiling from 1.85 million units in the twelve months through March 1985 to 2.3 million vehicles in the current restraint period helped erase a small 1984 decline, but the 20.1 percent market share captured by Japanese makes last year was still below the 1980-83 level (see accompanying table).

The financial news out of Detroit bolsters the argument that there is no longer any economic justification for continued restraints on Japan's car shipments to this country. Over the last three years the U.S. Big Three auto manufacturers have chalked up record or near-record profits, with 1985 earnings the second best on the books. More importantly, General Motors Corp., Ford and Chrysler are all pushing ahead with aggressive product development and capital investment programs designed to strengthen their competitiveness, particularly in small cars, while at the same time fighting to bring labor costs under better control.

Proponents of an end to Tokyo's export restrictions can also argue that 1986 is a good time to lift the restraints because changing conditions in the American automotive market are expected to put a lid on sales of Japanese-made cars. U.S. auto industry executives and analysts alike are predicting a drop this year in domestic demand for new cars. By itself, this downturn should limit import sales. In addition, though, Japanese suppliers have lost some of their price edge in the American market. The run-up in the yen's value since September has forced Toyota Motor Corp., Nissan Motor Co., Ltd. and Honda Motor Co., Ltd. to raise U.S. sticker prices by 3 to 4 percent on top of somewhat smaller increases at introduction time last fall. With the U.S. Big Three using cut-rate financing and rebates to move cars, the price differential between Japanese and American models has already shrunk, and it could narrow more this spring if the yen stays strong.

Weaker U.S. demand and higher Japanese sticker prices will make it hard for Japan's car manufacturers to expand U.S. sales this year beyond 1985's 2.2 million-plus tally. What could make it impossible is the arrival of other foreign competitors in the market's low end. Sales of the little subcompact brought in from Yugoslavia got off to a brisk start late last year, and Korea's Hyundai Motor Co. has pegged first-year sales of its Excel subcompact, slated for U.S. marketing in mid-February, at 100,000 units.

Susan MacKnight

U.S. Retail Sales of Imported Japanese Cars, 1980-85

(units)

Manufacturer/Seller	1980	1981	1982	1983	1984	1985
Toyota Motor Corp.	582,204	576,491	530,246	555,766	557,981	620,047
Nissan Motor Co., Ltd.	516,890	464,805	470,246	521,902	485,298	535,372
Honda Motor Co., Ltd.	375,388	370,705	365,865	350,670	374,819	406,413
Mazda Motor Corp.	161,623	166,105	163,638	173,388	169,666	211,093
Fuji Heavy Industries, Ltd. (Subaru)	142,968	152,062	150,335	156,840	157,385	178,175
Mitsubishi Motors Corp.	0	0	3,950	32,755	39,104	49,734
Isuzu Motors, Ltd.	0	17,805	15,462	20,731	17,233	26,953
Mitsubishi Motors Corp./Chrysler Corp.	129,350	110,940	102,227	103,569	91,718	105,213
Isuzu Motors, Ltd./General Motors Corp.	0	0	0	0	2,077	53,968
Suzuki Motor Co., Ltd./General Motors Corp.	0	0	0	0	10,927	30,892
Total Japanese Imports	1,908,423	1,858,913	1,801,969	1,915,621	1,906,208	2,217,860
Total Imports	2,396,934	2,326,376	2,221,398	2,382,799	2,439,848	2,838,116
Total Domestic Makes	6,578,275	6,206,296	5,756,660	6,795,302	7,951,517	8,204,542
Japan's Market Share	21.3%	21.8%	22.6%	20.9%	18.3%	20.1%

Source: Automotive News

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JAPAN ECONOMIC INSTITUTE

JEI

REPORT

NO. 5A

February 7, 1986

UPDATE ON JAPAN'S BIOTECHNOLOGY INDUSTRY: STUNTED GROWTH?

Summary

Mirroring developments in the U.S. industry, an increasing number of Japanese biotechnology firms are putting real products on the market. At the same time, more and more companies are entering the biotechnology field, translating into increasing amounts of money devoted to research. The government is trying to keep up with the fast moving industry, both in terms of research outlays and regulatory policy.

Despite all this activity, many observers have been disappointed with the pace of development in Japan. Others feel that Japan is right on schedule toward building a world-class industry. This examination will update Japan's technological and regulatory progress since JEI's last analysis (see JEI Report No. 8A, February 24, 1984).

Overview of Biotechnology

Biology was once mainly a descriptive science -- researchers classified the many types of organisms and noted gross and microscopic traits. In recent decades, however, biologists have begun to understand the causative mechanisms underlying their observations, raising the tantalizing possibility of modifying and manipulating biological phenomena. The discovery that the organization of molecules into cells and then into organisms is dictated by a blueprint contained in long sequences of nucleic acids known as deoxyribose nucleic acid, or DNA, opened the door to a new age of active biology.

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Although traditional biological techniques, including selective breeding and hybridization, have been used to modify the DNA code or genes of plants and animals, they are indirect, imprecise and time consuming. Armed with an understanding of what nucleic acid sequence produces a particular biological result, biotechnologists can directly manipulate or introduce new sequences into a cell's genetic code, producing almost immediate results.

The possibilities are endless, ranging from improved plant and animal varieties to new and less costly drugs and biological compounds, energy sources, industrial processes and even organic computers. The problems, however, are equally impressive. Identification of genetic sequences, as well as how genes interact with each other, is still in the early stages of development. Techniques to grow desirable cells outside of the parent body, to insert, activate and deactivate genes, and to process and recover the sought-after biological compounds have advanced to the commercial application stage, but there remains much room for improvement. Finally, researchers and entrepreneurs are beginning to delve more deeply into the ethical and environmental questions posed by the power of biotechnology.

Industry in Ferment

In JEI's first study on this subject, biotechnology fever was just beginning to spread in Japan. Although government agencies and a few companies had established biotechnology programs as early as 1979, interest in it did not spread to a wide range of industries until 1984. At that time, it appeared that the long-range benefits of biotechnical expertise outweighed the risks. Oil, chemical, glass, food processing and pharmaceutical firms caught the biotech bug, and many of Japan's new venture businesses also entered the field.

With the market for biotechnology products estimated at Y50 billion ($250 million at Y200=$1.00) this year, the incentive is strong. The outlolk for the industry is even more enthusiastic. Private analysts see the market growing to as much as Y5-Y8 trillion ($25-$40 billion) in 15 years, while various government agencies see the development of markets as large as Y15 trillion ($75 billion) by the beginning of the next century (see table).

The Ministry of Agriculture, Forestry and Fisheries reported that as of mid-1985, 389 companies and research institutes were engaged in biotechnology projects, of which 179 were private businesses and 210 were government-sponsored. The MAFF survey revealed that most of the private companies were focusing on pharmaceutical or food applications, while government laboratories were engaged in more esoteric applications, such as biosensors and biocomputers. On average, each private firm employed 19 researchers or engineers for each biotech project, far more than government institutions which reported an average staff of two. Many private-sector firms reported that they were actively collecting and analyzing genetic resources: an average of 2,000 samples of seeds and microbes had been gathered at the time of the survey. These efforts were augmented by collection programs at the local government level, which in some cases totaled as many as 1,500 samples.

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The Impact of Biotechnology on Japanese Products by the Year 2000

(in billions of yen)

Product	Production	Value Added
Rice and Grain	Y519	Y381
Vegetables	257	164
Fruits	13	9
Root Crops	13	8
Beverages	2	1
Food Products	91	66
Tobacco	12	9
Seeds	494	400
Dairy Farming	327	111
Meat	146	37
Wood Products	9	7
Fisheries	118	71
Copper Ore	17	13
Iron Ore	15	11
Nonferrous Ores	2	1
Petroleum	0	0
Dairy Products	590	150
Bread and Cakes	1,370	507
Sugar	108	13
Plant Oils	0	0
Flavorings	251	73
Animal Feeds	637	58
Alcoholic Beverages	1,113	662
Wood Pulp	90	17
Ammonia	17	4
Ethyl Alcohol	Y164	Y49
Methanol	52	14
Industrial Oils	75	19
Basic Petrochemicals	317	44
Other Petrochemicals	753	116
Textile Fibers	80	23
Fertilizers	0	0
Farm Chemicals	142	33
High-Pressure Gas	64	28
Other Basic Chemicals	73	34
Pharmaceuticals	3,151	1,564
Cosmetics	466	155
Consumer Chemicals	479	149
Oil Products	463	79
Electrical Copper	58	4
Nonferrous Products	242	46
Computers	188	80
Electronic Goods	287	103
Integrated Circuits	98	42
Medical Equipment	31	15
Propane	0	0
Underground Waterworks	479	303
Aboveground Waterworks	420	238
Waste Management	471	349
Total	15,003	6,312

Source: Ministry of International Trade and Industry

R&D Multiplies

As for research and development outlays, a Nihon Keizai Shimbun survey of 268 private companies shows extremely rapid growth. The companies queried are spending an average Y295 million ($1.5 million) on biotechnology projects in FY 1985 (ending March 31, 1986), a 51.5 percent jump over fiscal 1984, which itself represented a 28.2 percent increase. At the top of the company list is Mitsubishi Chemical Industries Ltd., with a FY 1985 budget of Y10 billion ($50 million). Furthermore, 41 percent of the companies expect to build or expand biotechnology facilities and, equally important, 74 percent intend to hire more researchers. As an indication of the relative youth of the field, only 52 percent of the respondents presently have facilities devoted solely to biotechnology research and these are staffed by just 17 people on average.

An October 1985 Ministry of International Trade and Industry survey presents older, but more comprehensive, data. Japanese industry spent a total of Y334.8 billion ($1.7 billion) in fiscal 1983 on biotechnology research, a 13.7 percent gain from the previous year. Not surprisingly, the manufacturing sector accounted for almost 99 percent of these expenditures. The chemical industry ranked first at Y280.7 billion ($1.4 billion), with pharmaceutical makers alone spending Y221.8 billion ($1.1 billion) on R&D; next came food processors with Y29.8 billion ($149 million). These figures represent growth rates of between 12.2 percent and 16.3 percent.

Although a general idea of the direction of Japanese biotechnology R&D can be gleaned from the preceding industry analysis, the picture is incomplete since many companies are using biotechnology to diversify into other lines of business. For example, Asahi Breweries Ltd. is pursuing the development of circulatory drugs, diagnostic kits and biosensors, as well as improved beer yeasts. Generalizations about the thrust of particular industries can still be made, if one also keeps in mind this trend toward diversification.

- Pharmaceuticals - Cancer diagnosis and treatment are the main targets of drug companies' biotechnology efforts. Alpha and gamma interferon, various interleukins, monoclonal antibodies and a tumor necrosis factor are being developed by several firms, and some have begun the long Health and Welfare Ministry approval process.

- Basic Chemicals - This group exhibits the most diverse projects, ranging from the more efficient production of basic chemical stocks to anti-pollution applications, food products and drugs. The only real generalization that can be made is that these firms seem to be looking for relatively quick returns on their investments to compensate for mature or sagging traditional markets. Licensing technology has been the usual pattern of development in this sector, although original R&D efforts are growing.

- Food Processors - After an initial wave of development directed at improving existing lines of business, food companies are beginning to expand into mass production of biological compounds. Growth hormones, blood-clotting factors, and other blood serum components are thought suitable for mass production via biotechnology. Research on more complex products, including monoclonal antibodies and tissue plasminogen activator (a blood-clot-dissolving compound), is also being pursued.

- Agriculture - Research aimed at improving terrestrial and marine plants as well as animal species is just beginning. Unlike U.S. researchers, Japanese horticulturalists have been somewhat slow to pursue the more daring options available through biotechnology, namely the insertion of foreign genetic material into plant cells. Recent plant introductions have offered yield improvements without significant departures from the basic plant stock. With increasing use of cell fusion techniques and the discovery of suitable vectors to introduce new genes into plant cells, Japan hopes to become a major player in the agri-products market by the next century.

- Electronics - This unlikely group is interested in the more esoteric biotechnologies, including biosensors and biocomputers. These areas of research are so risky that cooperation with the government is the norm. A more detailed discussion follows in the section on government policy.

An overall pattern is discernible in the development of Japan's industry that is not surprising. Most of the initial efforts have gone into areas where the country's strong tradition of excellence in fermentation could be applied -- continuous and large-batch production methods, and food- and drug-related applications. Now, however, the Japanese are beginning to expand into other areas they consider vital to future economic growth, leading to a heavier emphasis on basic research.

The Bottom Line

Now that they are several years old, a comparison of the financial data of U.S. and Japanese biotechnology firms is possible but must take into account the fact that many Japanese entrants often derive much of their income from non-biotechnology businesses. Direct company-to-company comparisons are therefore difficult, although not for major pharmaceutical firms (see JEI Report No. 45A, November 22, 1985). Nevertheless, it can be seen that biotechnology is becoming profitable. Several Japanese firms that produce assay or diagnostic kits as well as those that produce therapeutic biological compounds have hinted strongly that development costs are now being recouped. On this side of the Pacific, several biotechnology startups have announced their first profitable year, including Genentech Inc., Cetus Corp. and Applied Biosystems Inc. The increasing number of takeovers or mergers between biotechnology firms and other companies is also evidence of a better financial outlook.

For analytical purposes, stock prices can serve as a rough substitute for financial results. Several private indices of biotechnology stocks exist for both the Tokyo and New York Stock Exchanges. Unfortunately, these measures are also full of caveats. First, the companies included in each index may not be comparable, like apples and oranges. This shows up most clearly between the Japanese and American biotech indices because the Japanese tally the results of diversified companies such as Asahi Chemical Industry Co., Ltd., Mitsubishi Chemical Industries and Dainippon Pharmaceutical Co., Ltd., while in the United States, only pure biotechnology companies, such as Genentech, Centocor Inc. and Hybritech Inc., are included. There is also the question of which index to use. On the American side there are at least three: Paine Webber's, Kidder, Peabody & Co.'s and one put out by Bioengineering News, San Francisco, California. Across the Pacific, the picture grows more complicated.

Practically every major securities house has its own biotechnology index, in addition to an informal one followed by Nihon Keizai Shimbun.

Although details may differ, all show great variability in the stock price of biotechnology firms. According to Bioengineering News' Bioaverage, for example, the average stock price of three dozen U.S. biotech firms fell pretty steadily between April 1981 (a beginning value of 100) and August 1982 (when it rested at 59.60), rose through June 1983 (to 149.56), dropped again until December 1984 (to 71.37), then worked its way back up by December 1985 (107.67).

On the Tokyo Stock Exchange, where wide swings are much more the norm, the Nikkei biotech average has been extremely unstable. Although other factors are always involved, the average has diverged from the surges and ebbs of the overall market, often by wide margins. As the overall Tokyo exchange average leapt nearly 500 points between May 1984 and August of the same year, the biotech average moved up almost 700 points, then plunged almost 1,000. In 1985 both averages were better behaved, the overall index rising relatively steadily, while the biotech index made forward, but still erratic, progress.

International Genes

Joint ventures and international markets are an increasingly prominent feature of the Japanese and American biotechnology industries. Much of the activity is due to the extremely high cost of developing and marketing new products, especially pharmaceuticals. Many small U.S. biotechnology venture companies are tying up with large established firms, combining technology with production, distribution and marketing know-how. Foreign firms have been eyeing the Japanese market, which is second only to that of the United States, and recent government trade liberalization programs, particularly the acceptability of foreign clinical test data, have improved the chances of gaining a foothold. In addition to cost and market scale considerations, companies realize that technology knows no national boundaries. Japanese firms have long made excellent use of foreign technology, and foreigners are taking increasing advantage of what Japan has to offer. Companies involved in these joint ventures and technology exchanges are listed in an appendix to this report. The list is not meant to be exhaustive, but rather indicative of industry trends.

It is clear that U.S. biotechnology firms have been aware of the benefits of international cooperation for some time. At the beginning of the 1980s, U.S. firms were clearly ahead of their Japanese rivals but ready to share development costs with larger partners. This pattern of foreign money funding the development of U.S. technology has become widespread in recent years, although it does not necessarily translate into manufacturing or marketing rights. The appendix shows how both American and Japanese companies respond to the actions of domestic rivals. U.S. companies seem to be in a race to find large partners to pump cash into their operations, while Japanese firms are racing to obtain rights to cutting-edge technology. Finally, the appendix also shows a rise in the number of commercialization agreements heralding the appearance of biotechnology products in the marketplace.

Unlike other industries, therefore, biotechnology is developing as a global community, and a rapidly growing one at that. Japan's biotechnology market is certainly not lacking private-sector impetus, but the government is also contributing its fair share.

Shepherding Japan's Biotechnology Flock

Despite a program of stringent fiscal austerity, Tokyo continues to strengthen its support for biotechnology and other crucial research areas. While overall discretionary spending has decreased slightly in the past two fiscal years, funds for biotechnology programs within various government agencies have expanded at rates from 15 percent to 18 percent annually. For fiscal 1985, Tokyo will spend an estimated Y49.4 billion ($247 million) on biotechnology research, regulation and administration. Direct research expenditures remain relatively small, with much of the money that has been earmarked for life sciences funding operations of university departments, government institutes, administrative costs and gene banks. At the present time, one major thrust of government support is the creation of gene banks and the pooling of research data via an electronic network.

Leading the list in terms of spending is the Ministry of Education with outlays of approximately Y20 billion ($100 million), the vast majority of which flows into national research institutes and universities. MOE was first to take an interest in biotechnology and has been collecting genetic material and supporting research and education activities through the National Institute of Genetics since the late 1950s. At present, MOE is underwriting more than 80 gene bank projects: 23 related to animals, 27 on plants, 30 concerning microorganisms, and approximately 10 involving animal cells. Researchers at various universities are engaged in a wide range of studies on biosensors, synthetic cells and recombinant DNA technology.

In second place is the Ministry of Health and Welfare with a budget of approximately Y12 billion ($60 million). The bulk of these funds supports the complex pharmaceutical testing and approval system that is the bane of both domestic and foreign drug firms. MHW operates the National Institute of Health (patterned after the U.S. National Institutes of Health), the National Institute of Hygenic Sciences (patterned after the U.S. Centers for Disease Control) and several research centers located at Tsukuba Science City, north of Tokyo. The burden of developing safety guidelines for biotechnology research also falls on MHW's shoulders, although the Ministry of International Trade and Industry also has a say. In addition to a handful of small projects within NIH and NIHS, the ministry is beginning to fund some modest industry cooperative projects concerned with cancer treatment, including alpha interferon and interleukin-2. Finally, the agency also established a gene bank in 1984 to collect genetic material and establish collection guidelines, catalogue and offer a database on genes in the collection.

Next in line is the Ministry of Agriculture, Forestry and Fisheries with a budget of about Y10 billion ($50 million) for fiscal 1985. In cooperation with Kikkoman Corp., MAFF is trying to develop a cell fusion process to produce fertile hybrid plants. Similarly, a project with Kirin Brewery Co., Ltd. is aimed at faster development of hybrid seeds. A group of 14 private companies is exploring other cell fusion techniques with MAFF footing most of the projected Y30 billion ($150 million) cost of the eight-year program. To provide more direct aid, MAFF is planning to establish a biotechnology promotion center in fiscal 1986 with funds from dividends paid to the government by the recently privatized Japan Tobacco Inc. Its first-year goals include low-interest loans to 20 projects, accounting for most of the initial budget of Y5-Y6 billion ($25-$30 million). However, the project's outlook remains clouded due to fiscal considerations.

MAFF's National Institute of Agrobiological Resources has been carrying out biotechnology research since 1983. With a staff of 123 researchers, the institute's fiscal 1985 budget is a little over Y2.5 billion ($12.5 million). One of its projects has already yielded fruit; a patent is being sought on a new, heavier-bearing hybrid rice. Other research topics include plant virus studies and the mechanics of plant cell mutation and photosynthesis. MAFF's gene bank program is probably the most extensive, with repositories at NIAR, the Forest Experiment Station, the Vegetable and Ornamental Crop Research Station, the Fruit Tree Research Station, the Sericulture Experiment Station, the National Research Institute of Tea and 17 National Livestock Breeding Stations.

The Ministry of International Trade and Industry's biotechnology budget is only about Y4.2 billion ($21 million) this fiscal year, but because it is not burdened with administrative duties, it actually funds an equivalent amount of research as the previous ministries. More importantly, much of the MITI-sponsored research is conducted in cooperation with private firms and concentrates on commercial applications of biotechnology.

Under the Research and Development Project on Basic Technology for Future Industries, a 10-year program begun in 1981, bioreactors (immobilized enzymes, subsitution of enzymes for catalysts and recycling of co-enzymes), large-scale cell cultivation (suspension culture, culture of epithelial cells and differentiation cultures) and recombinant DNA applications (high-oxidation and secretory microorganisms) are being developed. The Fermentation Research Institute also funds various research projects, but is equally interested in establishing a Patented Microorganism Depository. As Japan's only designated international patented microorganism institute (under the Budapest Agreement), the facility can house at least 7,000 strains of microorganisms and hopes to become an important part of the international biotechnology industry.

Organic electronics, including biocomputers, seem to have caught the fancy of MITI planners. The Japan Key Technology Center, a non-profit organization established by MITI, has recently joined forces with five Japanese companies to develop techniques to modify natural proteins for use in bioelectronics. In addition to providing one-third of the research staff, the government may lay out up to 70 percent of the 10-year project's Y30 billion ($150 million) budget. Mitsubishi Chemical Industries, Takeda Chemical Industries Ltd., Kyowa Hakko Kogyo Co., Ltd., Toray Industries Inc. and Toa Nenryo Kogyo K.K. will provide the remaining funds and personnel. MITI also wants to spend Y8 billion ($40 million) over the next decade on an organic computer modeled after the human brain. As part of this program, NEC Corp. and MITI's Electrotechnical Laboratory have begun work on bioelectronic circuits, the first step toward an analog computer.

MITI is also involved in promoting biotechnology businesses through the Office of Biotechnology and the Venture Enterprise Center. The former acts as a clearinghouse for technical information while the latter helps startup firms with capital and management consulting.

The Science and Technology Agency, part of the Prime Minister's Office, is also heavily involved in biotechnology research. With a biotechnology budget slightly less than MITI's, STA suppports several domestic and international programs, of which the most prominent is the Institute of Physical and Chemical Research (RIKEN). With facilities in several locations, including Tsukuba, RIKEN is at the forefront of biosensor developments. It also opened a maximum security containment facility (P4 level) for recombinant DNA work in September 1985.

Government biotechnology research and development activities are focused on commercialization in several key areas. This approach, however, has been criticized as Japan nears the frontiers of technology. There is a growing awareness that support for broad basic research must be improved if Japan is to catch up with the United States and Europe in non-fermentation fields.

Keeping the Flock Under Control

Regulatory policy is becoming increasingly crucial as more and more products near the commercialization stage. The details of the issues involved are complex and esoteric, but the overall problems can be easily grasped. Japan is actually having a somewhat easier time of developing regulations than the United States because it tends to rely heavily on American models. Moreover, because Japanese industry is not engaged in the more unusual applications of biotechnology, the regulatory problems are lighter.

In general, MITI and MHW have been cautious about approving human-related applications, but accommodative to industrial uses. MITI is committed to making Japan a top-flight competitor in biotechnology, while MHW continues to refuse risking the nation's health. The extent of Japan's regulatory web is probably second only to the United States. After a year of study by a semi-public advisory council, the Ministry of Education adopted recombinant DNA experiment guidelines in early 1979. The Science and Technology Agency followed with nearly identical regulations later that year. These initial rules were considered more stringent than those followed by the U.S. National Institutes of Health, although this did not present a problem since research was just getting under way.

Within a few years, however, revisions had become necessary to keep abreast of maturing technologies. By mid-1983 significant changes had been made in the original guidelines in regard to large-scale experiments and allowable hosts and vectors for recombinant DNA work. If the organisms involved present relatively low risks (physical containment levels P1 and P2), experiments can proceed without government approval. More dangerous microbes (levels P3 and P4) require government supervision as well as permission.

A number of leading-edge experiments are currently prohibited, although approval may be granted on a case-by-case basis. Chief among these is a ban on the deliberate release of modified microorganisms into the environment. A similar rule is in effect in the United States and lies at the center of heated debate and litigation. There are probably upward of 100 experiments awaiting approval from the Environmental Protection Agency, some privately sponsored, others as components of government programs. (The U.S. Department of Agriculture alone has 80 to 90 release experiments lined up.) At present, no Japanese companies are contemplating this kind of experiment, but Japanese officials are concerned that domestic companies will soon seek such permission and are wrestling with additional guidelines.

As for plant and animal experiments, guidelines published by MOE in February 1984 are extensive, though apparently not to the point of hindering research. In addition to those projects mentioned earlier, experiments involving human cancer-causing genes in mice and bacterial and pathogenic genes in plants are in progress.

The greatest regulatory barrier to biotechnology products is the maze of pharmaceutical regulations maintained by the Health and Welfare Ministry. Foreign drug companies have shown increasing interest in Japan's market and the recently concluded sectoral negotiations between the United States and Japan yielded some significant changes. MHW's willingness to accept foreign clinical data if racial differences are not a factor is probably the most important policy shift (see JEI Report No. 2B, January 17, 1986). This, along with other procedural changes, should hasten the approval process and improve relations between the ministry and foreign drug manufacturers.

Although MITI is on the verge of releasing industrial biotechnology guidelines, it may wait for the Organization for Economic Cooperation and Development's Committee for Scientific and Technological Policy to adopt a single set of biotechnology guidelines this month. The Japanese delegation was successful in arguing that the regulations should not hinder large-scale industrial and agricultural uses of biotechnology, since only well-tested processes and relatively harmless products are involved. Not only will uniform international regulations make MITI's job easier, it will probably speed the global introduction of biotechnology products.

The development of safe and flexible guidelines is still at an early stage. Means of judging the long-term impact of experiments both on subjects and the environment are in the formative stage, to say nothing of the delicate ethical questions involved, including somatic therapy and gene screening.

Thoughtful Problems

Equally important and difficult are questions concerning intellectual property policy. In view of the many millions of dollars expended to develop and bring a biotechnology product to market, businessmen are naturally interested in protecting their investment. Since useful genes can be produced with relative ease if one knows the proper sequence, the temptation to copy publicly announced developments is strong. In fact, companies no longer display exact genetic sequences at press briefings out of concern for such illegal reproduction. So far, policymakers have turned to existing copyright and patent laws to develop legal protections -- copyright law to cover specific products and patent law to safeguard the underlying technology.

An oil-eating microbe engineered by Dr. Ananda Chakrabarty of General Electric Co. became the first patented microorganism on June 16, 1980 after eight years of litigation. The decision was a major extension of patent law to cover living organisms and helped foster the growth of the American industry. On October 10, 1985, the patent mantle was expanded again to include genetically engineered seeds, plants and plant tissues. Plants produced by traditional sexual and asexual techniques have been granted patent protection in the past, but a U.S. Patent Office decision could have a major impact on the $3 billion seed business. Genetic engineers can now patent and license a new plant while it is still in the test-tube stage, possibly generating enough revenue to fund its commercialization.

While microorganisms have been patentable in Japan since 1979, Tokyo is in the midst of amending the patent law to include genetically engineered microorganisms. Unfortunately, agreement between the various ministries and the private sector is proving to be elusive. Prior to August 1985, new plant varieties (however produced) were eligible for protection under the Seed and Sapling Law of 1978, and in some cases the patent law. The Patent Office and the Ministry of Agriculture agreed, however, that all new plant breeds would be excluded from patent protection. Under the Seed and Sapling Law, only the method used to develop the new breed can be protected. A Japanese farmer who plants registered hybrid seeds, for example, would be free to use any seeds harvested to replant next year's crop. Commercial sale of registered seeds, however, remains the exclusive right of the developer.

In an effort to promote a global industry, the OECD issued a report in October 1985 recommending improved protection for biotechnology products. The principal points are:

- Inventors should be granted a grace period during which patent claims can be submitted at the international level.
- Microorganisms per se should be patentable.
- Naturally occurring microorganisms should be patentable if newness and industrial applicability can be proved.
- Deposit or description of microorganisms should complement repeatability (of an experiment) requirements.
- Guidelines must be developed covering the release of microbes.
- Protection for plant materials should be improved.
- Inanimate products of nature should be patentable.
- Patent office procedures should be expedited.
- Academic researchers should be encouraged to patent results.
- More systematic study must be given to infringement penalties.

Whether these OECD guidelines will help produce uniform international protection is unclear.

Outlook

To summarize, Japan's biotechnology industry has made steady progress. By parlaying their strength in food fermentation into positions as manufacturers of biotechnology products, Japanese companies are positioning themselves for a long-range development program that could put them at the top of the heap. The government is trying to foster this trend with judicious applications of money and the careful construction of regulatory and intellectual property policies. Nevertheless, the industry continues to exhibit major weaknesses.

By focusing on applications with immediate commercial use, Japanese companies may be neglecting the bolder experiments that could be the key to future leadership. Although the incremental approach has served them well in the past, the chances of being left even farther behind are not insignificant. An increased national emphasis on basic research should help ameliorate this situation, but time considerations may make gradual improvements moot.

Decidedly absent from Japanese efforts is work on outer space biotechnology. Several processing experiments aboard the U.S. space shuttle have proven the value of a micro-gravity environment, but Japanese firms have not reserved space on any scheduled space flight. Given the U.S. lead in space flight, it is understandable that the contrast appears lopsided. Beside producing a module for the U.S. space station, the government is just beginning to organize private groups to commercialize space. If Japan fails to gain significant space processing experience before the turn of the century, any original advantages may be nullified.

In recognition of these weaknesses, international cooperative programs are being launched by the government and private industry. Japan and France inked an agreement in April 1985 to exchange genetic resources as the first step toward full cooperative research. In December of that year, the Institute of Physical and Chemical Research also established a global data center and repository for microbes as part of the World Federation for Culture Collections. The center's goal is to store 500,000 to 600,000 strains of microorganisms and provide global access via telephone beginning in 1987. Finally, MITI is encouraging the Bio Industry Development Center to widen its membership and establish exchange programs with counterparts in the United States and Europe. Through BIDEC, MITI will also try to fund research in foreign as well as domestic universities. The realization that only through true internationalization can Japan's biotechnology industry prosper into the next century is rapidly becoming a policy keystone. Although a host of obstacles remain to be overcome, Japan's biotechnology industry has yet to show signs of stunted growth.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix

Examples of International Joint Ventures and Technology Exchanges in the Biotechnology Field

- Collaborative Research Inc. and Green Cross Corp. of Japan decide to cooperate on interferon development. (February 1981)

- Genex Corp. and Mitsui Toatsu Chemicals Inc. agree to work to produce urokinase (a clot-dissolving enzyme) via biotechnology. (June 1981)

- Enzo Biochem Inc. sells worldwide marketing rights to its monoclonal antibody-based diagnosis kits to Meiji Seika Kaisha Ltd. (May 1982)

- Shionogi & Co., Ltd. and Biogen Inc. begin gamma interferon cooperative research. (June 1982)

- Genentech Inc. and Mitsubishi Chemical Industries Ltd. begin cooperative research on producing human serum albumin through recombinant DNA techniques. Mitsubishi subsequently obtains license to sell Genentech's tissue plasminogen activator technology in the Japanese market. (May-June 1982)

- Teijin Chemicals Ltd. funds monoclonal antibody research by Hybritech Inc. in exchange for marketing rights in Japan and the Far East. (November 1982)

- Biogen Inc. begins an agreement spree with Japanese companies. Recombinant DNA technology for producing Factor-VIII went to Teijin Ltd.; tissue plasminogen activator know-how to Fujisawa Pharmaceutical Co., Ltd.; hepatitus-B vaccine research to be conducted with Green Cross Corp.; and interleukin-2 to be developed with Shionogi & Co., Ltd. (Starting January 1983)

- Integrated Genetics Inc. sells marketing rights to recombinant DNA diagnostic compounds to Fuji Rebio Inc. and tissue plasminogen activator to Toyobo Co., Ltd. (March 1983 and November 1983)

- Genex Corp. and Yoshitomi Pharmaceutical Industries Ltd. begin cooperative research on producing interleukin-2 via engineered microbes. (July 1983)

- Toyo Soda Manufacturing Co., Ltd. supports research on monoclonal antibodies for cancer diagnosis by Hybritech Inc. (November 1983)

- Genentech Inc. licenses Fujisawa Pharmaceutical Co., Ltd. to market the U.S. firm's tumor necrosis factor in Japan. (June 1984)

- Sumitomo Chemical Co., Ltd. buys rights to develop Biogen Inc.'s Somatomedin-C in Japan. (June 1984)

- Sankyo Co., Ltd. agrees to fund development of tumor necrosis factor and macrophage activating factor by Great Britain's Celltech Inc. (October 1984)
- Chugai Pharmaceutical Co., Ltd. funds development of erythropoetin by Genetics Institute Inc. (November 1984)
- Plant Genetics Inc. begins work on synthetic seeds with Kirin Brewery Co., Ltd. (January 1985)
- LKB-Produkter AB of Sweden establishes a Japanese subsidiary to sell its medical analysis equipment using biotechnology. (January 1985)
- Suntory Ltd. purchases manufacturing and marketing rights to Schering-Plough Corp.'s gamma interferon technology. (February 1985)
- Takeda Chemical Industries Ltd. buys alpha interferon technology from Genentech Inc. (February 1985)
- Integrated Genetics Inc. sells marketing rights to its erythropoetin to Toyobo Co., Ltd. for all areas other than the United States and Europe. (February 1985)
- Toray Fujibionics Co., Ltd. will fund research at Centocor Inc. in exchange for marketing rights to Centocor's oncogene (cancer-related) products. (March 1985)
- G.J. Ball Inc., a Chicago-based seed company, joins Toyo Menka Kaisha Ltd. and Mikado Seed Growers Co., Ltd. in developing and growing hybrid seeds. (March 1985)
- Toyo Menka Kaisha Ltd. will help Britain's Cogent Ltd. introduce its biotechnology into Japan, including tissue plasminogen activator, pro-urokinase and an anti-thrombolitic agent. (June 1985)
- Otsuka Pharmaceutical Co., Ltd. opens a research facility in Rockville, Maryland, the first such Japanese presence in the United States. (June 1985)
- Yamasu Shoyu Co., Ltd. sells its monoclonal antibody know-how to Celltech Ltd. (July 1985)
- Biogen Inc. agrees to let Suntory Ltd. market its tumor necrosis factor in Japan. (November 1985)

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JAPAN · ECONOMIC · INSTITUTE

JEI

REPORT

NO. 5B
February 7, 1986

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Japan Reduces Its Discount Rate

On January 30 the Bank of Japan lowered the official discount rate 0.5 percentage point to 4.5 percent in an effort to expand domestic demand. The discount rate, the rate the central bank charges on loans to commercial banks, had been set at 5 percent since October 1983. Despite the bank's action, the yen continued to appreciate, reaching the Y190=$1.00 level on February 3.

trade deficit of $148.5 billion, as well as Finance Minister Noboru Takeshita's statements that Japanese industry could live with the yen at the 190 level. There was also speculation that the United States would in fact cut its discount rate.

Randall S. Jones

Reagan Proposes Study Of Exchange Market Stability

President Reagan, in his State of the Union address, directed Treasury Secretary James Baker to study the feasibility of a worldwide conference on the international monetary system and report back to him by the end of the year. Mr. Reagan said he favored removing "some volatility" from the current exchange-rate system. Although Mr. Baker expressed willingness last April to consider such a conference, the presidential directive will add momentum to the push for reform of the international monetary system.

The president's statements illustrate the shift in the administration's stance on exchange rates. During its first term, the Reagan administration supported the floating exchange rates and rejected intervention except in cases of "disorderly markets." At the September Group of Five meeting, however, the United States agreed the dollar was overvalued and pledged to intervene in exchange markets to lower its value. The president's request to Mr. Baker indicates a willingness to consider reforms to the current international monetary system.

On Capitol Hill there have been some proposals for reform of the international monetary system, notably by presidential aspirant Jack Kemp (R, N.Y.). It is unlikely, though, that the administration is ready to propose a return to fixed exchange rates or a system of target zones, which establishes bands in which currencies move against each other. One important objective of the president's proposal is to demonstrate the White House's recognition that volatile currency swings are an important issue and to assuage American industry, which has been hurt by the high dollar. In addition to fighting protectionism, the administration hopes to see a further gradual decline of the dollar.

It is unclear how much international support there is for reform of the present exchange-rate system. Although the Treasury secretary believes that there is growing support for more stable exchange rates, an April 1985 report by the eleven-largest industrial countries suggested few changes in the current system.

Randall S. Jones

Japan's 1985 Balance Of Payments Sets New Records

According to preliminary Ministry of Finance figures, Japan's balance of payments figures recorded several new highs and lows in 1985 (see Table). Perhaps most troubling to Japanese policymakers is the continued rise of the nation's trade and current account surpluses despite drastically slowed export growth. On the other hand, Japan is very actively recycling this bounty as indicated by the record net long-term capital outflow.

Japan's Global Balance of Payments

(in millions dollars, IMF value basis, seasonally unadjusted)

	1981	1982	1983	1984	1985*
Exports (f.o.b.)	$149,552	$137,663	$145,468	$168,290	$173,928
	(18.0%)	(-7.9%)	(5.7%)	(15.7%)	(3.4%)
Imports (f.o.b.)	129,555	119,584	114,014	124,033	117,926
	(4.0)	(-7.7)	(-4.9)	(8.8)	(-4.9)
Trade Balance	19,967	18,079	31,454	44,257	56,002
Services	-13,573	-9,848	-9,106	-7,747	-5,075
	(-19.6)	(27.4)	(8.0)	(14.9)	(-34.5)
Transfers	-1,624	-1,381	-1,549	-1,507	-1,656
	(-6.3)	(15.0)	(-13.5)	(2.7)	(-9.9)
Current Account Balance	4,770	6,850	20,799	35,003	49,271
Long-Term Capital	-9,672	-14,969	-17,700	-49,651	-64,807
	(-516.2)	(-54.8)	(-18.9)	(-180.5)	(-30.5)
Basic Balance	-4,902	-8,119	3,099	-14,648	-15,536
Short-Term Capital	2,265	-1,579	23	-4,295	-660
	(-27.9)	(-169.7)	(111.1)	(-18,773.9)	(84.6)
Errors & Omissions	493	4,727	2,055	3,743	3,878
Overall Balance	-2,144	-4,971	5,177	-15,200	-12,318

*Preliminary figures.

Note: Figures in parentheses are percentage changes from previous year.

For the second year in a row, the margin between the value of exports and imports increased by about $12 billion dollars, pushing the surplus to new heights. Weakening commodity prices combined with continued strong demand for Japanese goods depressed the value of imports and drove up the value of exports. The impact of the yen's rise during the second half of the year was not enough to counteract first-half gains. (Exports in yen terms rose 3 percent in 1985 compared with 3.4 percent in dollar terms.)

Japan's deficit in services trade continued to narrow during 1985, indicating improving international competitiveness in this area. While rapidly escalating investment income is responsible for the majority of the narrowing, it is not clear if this trend will continue in the coming years. Due to new opportunities in Japan's liberalized telecommunications and financial markets, possible improvements in market access in the legal field and in air and sea transportation services, foreigners' chances to capitalize on their expertise on Japanese turf may improve. For now, however, the result of a rising trade surplus and shrinking services deficit is a record current account surplus.

Nineteen hundred eighty-five will be remembered as the year Japan became the world's top creditor nation and the United States became a net debtor nation. This is underscored by Japan's record net long-term capital outflow.

MOF estimates that Japanese bought $291.3 billion worth of foreign bonds while selling $237.9 billion abroad for a deficit in bond sales of $53.5 billion. The previous record set in 1984 was $26.8 billion when purchases totaled $56.4 billion and sales amounted to $29.6 billion. In December's equity markets, Japanese investors also were net buyers of foreign stocks (by $226 million) and net sellers in their own markets (by $125 million), indicating strong interest in foreign financial instruments. As a result, an average $5 billion-a-month net torrent of funds out of the country easily dwarfed the current account balance surplus and kept the country's overall balance in the red for the year.

Jon Choy

Japan's Oil Appetite Continues To Shrink

Japanese officials are pointing to lower crude oil prices as a major cause of reduced imports in 1985, on both a customs clearance (see JEI Report No. 4B, January 31, 1986) and a balance of payments basis (see article in this issue). Not only has the price of oil been declining, but Japan's absolute imports of various products have also been shrinking.

The Ministry of International Trade and Industry reports that Japan imported 7.6 percent less crude oil during 1985, a total of 198.3 million kiloliters. By diversifying its sources, Tokyo has reduced the share bought from the Organization of Petroleum Exporting Countries to 73.3 percent from 77.7 percent the previous year. The biggest loser among OPEC countries was Saudi Arabia. Possibly because of Saudi refusal to discount its oil, purchases by Japan sank 40.9 percent to just 34.5 million kiloliters. Shipments from the United Arab Emirates jumped 29 percent to 42.2 million kiloliters, partially compensating for the Saudi loss. Imports from other countries were mixed. Purchases of Indonesian crude fell 19.7 percent to 22.6 million kiloliters, while those from nearby Malaysia rose 3.3 percent to 6.6 million kiloliters.

Import price trends clearly show the impact of the strengthening yen as well as falling global prices (see Table). In terms of dollars per barrel, prices declined steadily over the first six months of 1985 and have since held steady. In yen terms, however, prices have entered a free fall that is likely to continue at least until the yen-dollar exchange rate stabilizes.

The price Japan pays may show even steeper declines in 1986 for two reasons. First, OPEC will continue its efforts to regain market share through price reductions, undoubtedly pushing down the price of non-OPEC oil as well. Spot market prices have already fallen far below the $28 dollar-a-barrel for Saudi Arabia's benchmark Arabian Light. Second, OPEC is negotiating "netback" contracts with European and Japanese customers, promising even greater savings. Under this arrangement, oil producers refund the cost of shipping the crude to customers and part of the refining costs. Saudi Arabia has already signed such contracts with European buyers, yielding a price of approximately $19.80 a barrel. The OPEC linchpin has also sealed pacts with three Japanese firms. Kyodo Oil Co., Ltd. will purchase 70,000 barrels a day over the next six months; Marubeni Corp. will take delivery of around 50,000 barrels a day; and Mitsubishi Corp. has agreed to 100,000 barrels a day for the same period.

Although the Japanese have not announced the actual prices, analysts expect them to be about 50-60 cents a barrel above European levels because of greater transportation costs.

The economic impact of these reductions may not be as great as one might expect. Although Japan is almost completely reliant on foreign sources of energy, conservation and diversification programs have decreased the impact of oil prices on the economy. The political effects may actually be greater than the economic ones. If Japan's total import bill continues to fall because of cheaper oil, it could widen the country's global trade surplus and heighten trade tensions. While such a situation could hardly be blamed on the Japanese, Congress is not always swayed by rational arguments.

Jon Choy

Japan's 1985 Imports of Crude Oil

	Volume (1,000 bbl)	Import Bill ($1,000,000)	Dollars per Barrel	Yen per Kiloliter
January	99,017	$2,881	$29.10	Y46,379
February	113,471	3,258	28.71	46,352
March	126,586	3,583	28.30	46,379
April	108,206	3,067	28.34	45,371
May	101,389	2,871	28.32	44,769
June	74,297	2,107	28.36	44,636
July	89,997	2,511	27.90	43,213
August	91,029	2,497	27.43	41,045
September	95,073	2,602	27.37	41,173
October	109,415	2,991	27.34	38,073
November	97,004	2,687	27.70	36,468
December	115,169	3,217	27.93	35,590
1984 Total	1,341,034	39,379	29.36*	43,713*
1985 Total	1,220,653	34,272	28.07*	38,589*

*Average annual prices.

Sources: Ministries of Finance and International Trade and Industry

Ministers Urge Wider Japanese Role In International Community

Sounding a familiar theme, Prime Minister Yasuhiro Nakasone, Foreign Minister Shintaro Abe and Finance Minister Noboru Takeshita all called upon Japan to assume a role in the international arena commensurate with its economic prowess at the opening session of the Diet January 27. Each minister essentially underscored consistency in current policies, with an emphasis on expanding those policies to reflect a greater Japanese global role.

The prime minister emphasized his continued commitments to regional defense, the internationalization of the yen, wider market opening measures to enable overseas partners to sell more products in Japan, and restructuring the domestic economy to bring it in line with international standards. While vague in certain areas -- particularly on the domestic economic issues -- he nevertheless indicated that the thrust of policies initiated during the first three years of his administration would be continued. For example, he emphasized fulfilling the goals of the national defense plan in a manner consistent with the country's conventional limitations, although he avoided specific reference to limiting total defense spending to one percent of the country's gross national product.

Foreign Minister Abe continued this tone, noting the importance of recent developments in improving ties with the Soviet Union, China, Southeast Asia and South Korea. Some observers suggested that this prominent mention of Asian nations suggested a shift in Tokyo's priorities in foreign affairs, but it was more likely an indication that Japan is indeed assuming -- slowly but surely -- a greater international role. Policymakers have made a conscious effort over the past three years to broaden contacts with nations that have often accused Tokyo of paying little attention to them. In addition, Mr. Abe emphasized his personal commitment to expanding Japan's role in international aid and relief programs and said that the Japan-U.S. relationship remained the cornerstone of Japan's foreign policy planning.

While focusing more heavily on domestic economic issues, Mr. Takeshita reiterated the prime minister's commitment to yen internationalization and expanded on his plans to re-structure the domestic economy through tax reform. The finance minister implied that the subject would be a major issue in the current session of the Diet, although legislation is not expected until next summer at the earliest. If overseas observers were looking for hints of domestic stimulus, there were few to be found; Mr. Takeshita consistently emphasized continued fiscal austerity to bring budget deficits under control.

The speeches contained few surprises, but in several respects were reassuring. Japan's allies will know what to expect from Tokyo in the months to come. While this may suggest continued frictions on the trade front, it represents Japan's commitment to move in the direction it sees as proper in the international trading system. Calls for further international cooperation in monetary talks, a multilateral trade negotiating round and intense discussions in the upcoming Tokyo summit -- a major policy priority for Japan -- reflect this momentum and the consensus among Japan's leadership. The question is whether Tokyo's pace will satisfy its partners in the West and in Asia.

Michael W. Chinworth

Japan's Foreign Policy Puts Renewed Focus On Asia, Improved Ties With ASEAN

Japanese officials have declared a renewed foreign policy emphasis on the Asian-Pacific region. In a speech to the Diet and during a meeting with business leaders January 27, Foreign Minister Shintaro Abe underlined the importance of Japan's ties with its Asian neighbors. In a statement reminiscent of the language of the Fukuda Doctrine, he declared that "Our relations with the Asia-Pacific countries have recently taken on new depth and breadth and I intend to promote a foreign policy emphasizing not just relations between countries but also the bonds between people and the warmth of heart-to-heart encounters."

Mr. Abe placed particular importance on ties between Japan and the six member states of the Association of Southeast Asian Nations during his talk with leaders of the business community. The foreign minister suggested that if necessary, Japan must "sacrifice" its own interests for the benefit of encouraging economic growth in the region. Japanese relations with ASEAN (Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand) have been under some strain in recent years due largely to the pattern of trade between them. ASEAN claims that Japan's imports from the region, despite heavy purchases of oil and liquefied gases, are dropping overall, and that raw materials make up the bulk of imports rather than processed agricultural products and manufactured goods of greater value.

Indeed, preliminary figures for 1985 indicate that two-way trade between Japan and ASEAN dipped by about 13 percent compared to the year before, totaling a little over $31 billion, down from 1984's $36.2 billion (see Table). In the process, though, Japan's overall trade deficit with the group grew from $7.9 billion to $8.8 billion-plus as exports dropped by 20 percent while imports declined by only 9 percent.

In bilateral terms, only oil-rich Brunei bought more Japanese goods in 1985. Exports to the other countries dropped between 12 percent and 29 percent, with Indonesia and Malaysia recording the largest cuts in purchases. Growth in both nations has been sluggish over the past several years as a result of the downturn in world petroleum prices, a slowdown in agricultural production and strict government economic policies. For different reasons, Singapore, Thailand and the Philippines have also been suffering through tough economic times, a fact reflected in Japan's smaller shipments to them.

Conversely, falling oil prices plus a big drop in the volume of crude bought from Indonesia (see article in this issue) help explain the drop in the import column. So do lower prices for the other industrial and agricultural inputs Japan buys from the six nations. In fact, Japan's purchases from ASEAN dipped in every instance. Japanese officials rightly expect renewed criticism from the group due to this development.

In light of Mr. Abe's announcement, the Foreign Ministry has indicated that its new foreign policy emphasis will require a review of Japan's foreign aid policies. One high-level advisory panel has already submitted recommendations for aid policy reform to the foreign minister (see JEI Report No. 1B, January 10, 1986). A ministry official has indicated that a study group on Japan-ASEAN relations will be established, which would, among other things, make recommendations on how to improve Japan-ASEAN trade relations in time for a meeting of ASEAN foreign ministers and ASEAN Dialogue partners scheduled for June.

The same official told newsmen that Japan's new aid policy will take a more "general" approach and focus on "non-project" aid, including Indonesia's agriculture development program and Thailand's east coast industrial development plans. The increased use of commodity loans is also reportedly under discussion. Finally, Japan intends to expand its use of international agencies to help target and distribute assistance.

Sheri Hoptman

Japan's Trade with ASEAN, 1980-85

(in millions of dollars; exports f.o.b., imports c.i.f.)

	1980	1981	1982	1983	1984	1985
Brunei						
Exports	$ 88	$ 93	$ 145	$ 86	$ 72	$ 81*
Imports	3,245	2,907	2,636	2,367	2,202	1,727*
Trade Balance	-3,156	-2,814	-2,491	-2,281	-2,131	-1,646*
Indonesia						
Exports	3,458	4,123	4,261	3,552	3,073	2,170
Imports	13,167	13,305	12,005	10,432	11,175	10,117
Trade Balance	-9,709	-9,182	-7,744	-6,880	-8,102	-7,947
Malaysia						
Exports	2,061	2,424	2,502	2,771	2,875	2,167
Imports	3,471	2,927	3,010	3,131	4,412	4,309
Trade Balance	-1,410	-503	-508	-360	-1,537	-2,142
Philippines						
Exports	1,683	1,928	1,802	1,744	1,080	952
Imports	1,951	1,731	1,576	1,306	1,419	1,242
Trade Balance	-268	197	227	437	-338	-290
Singapore						
Exports	3,911	4,468	4,373	4,448	4,610	3,860
Imports	1,507	1,944	1,826	1,468	1,775	1,594
Trade Balance	2,404	2,524	2,547	2,981	2,835	2,266
Thailand						
Exports	1,917	2,251	1,907	2,506	2,425	2,030
Imports	1,119	1,061	1,041	1,019	1,040	1,027
Trade Balance	797	1,189	966	1,488	1,385	1,003
Total ASEAN						
Exports	13,118	15,287	14,990	15,107	14,134	11,260
Imports	24,461	23,876	22,094	19,722	22,024	20,016
Trade Balance	-11,343	-8,589	-7,103	-4,615	-7,887	-8,756

*Data for Brunei are for eleven months.

Source: Japan Tariff Association

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REPORT

NO. 6A

February 14, 1986

THE U.S. INTERNATIONAL TRADE COMMISSION: COPING WITH THE RULES OF TRADE

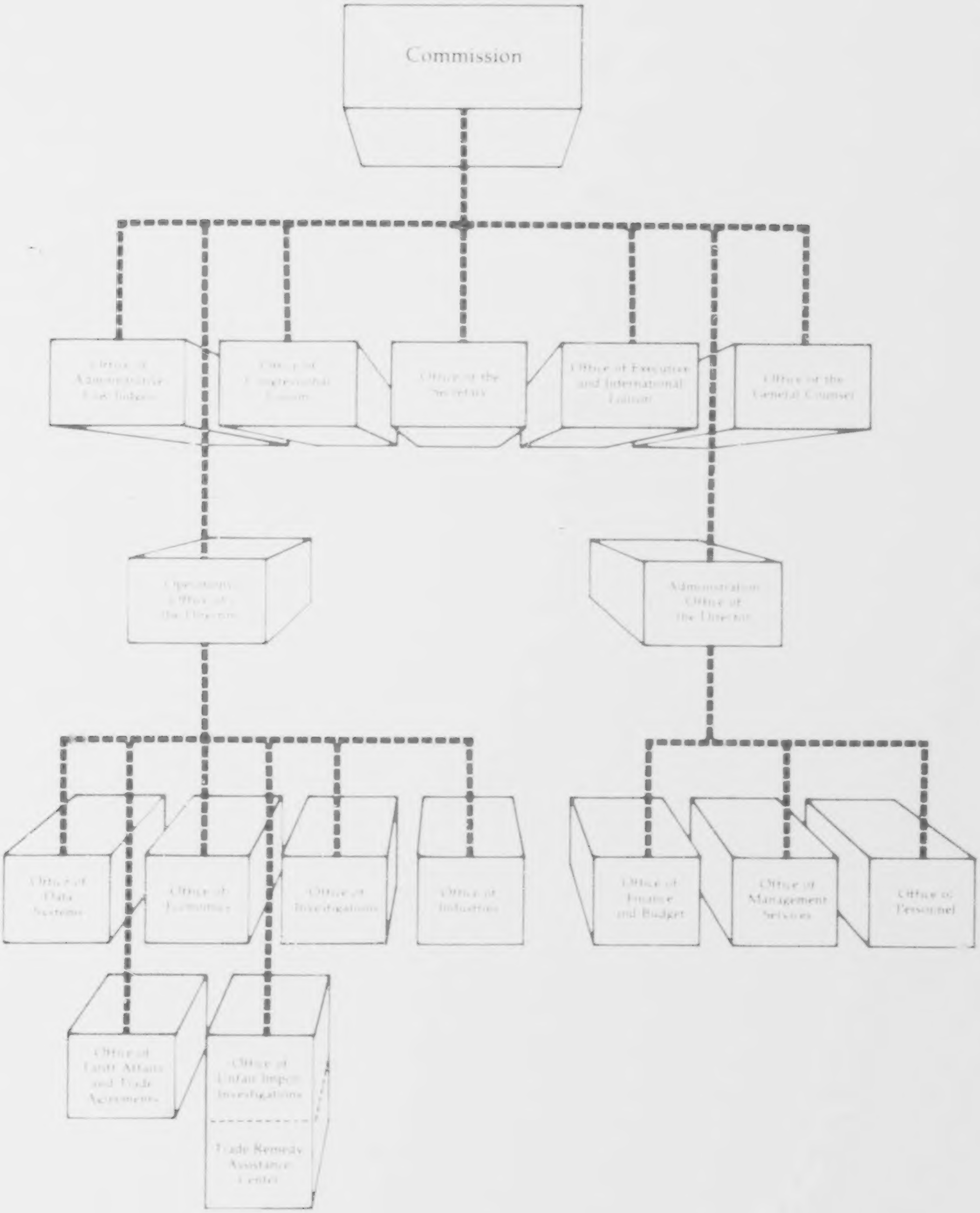
Summary

The U.S. International Trade Commission plays a large and growing role in trade policy implementation and, some say, in the formulation of trade policy itself. Yet few realize the variety of tasks that the six presidentially appointed commissioners preside over, or the constraints on them as they go about their duties.

This report will analyze the ITC's role in the trade policy process by focusing on its history and activities as well as its relations with the executive and legislative branches of government. The report will subsequently examine some of the issues facing the commission, illustrating the complexity of the ongoing trade reform debate and the manner in which trade and politics so frequently intersect.

Form and Function

The U.S. International Trade Commission is an independent, bipartisan, quasi-judicial agency charged with investigating all the factors relating to the effect of U.S. foreign trade on domestic production, employment and consumption. By Washington standards, the commission hardly qualifies as a bureaucracy in terms of size; it employs well under 500 people, and its staff has not grown appreciably in some forty years. Its administrative layout is also deceptively simple (see Chart). Yet even a cursory listing of the ITC's


Commission
Office of Administrative Law Judges
Office of Congressional Liaison
Office of the Secretary
Office of Executive and International Liaison
Office of the General Counsel
Operations Office of the Director
Administration Office of the Director
Office of Data Systems
Office of Economics
Office of Investigations
Office of Industries
Office of Finance and Budget
Office of Management Services
Office of Personnel
Office of Tariff Affairs and Trade Agreements
Office of Unfair Import Investigations
Trade Remedy Assistance Center

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functions betrays the complexity of its mission -- 22 types of investigations, studies and reports are authorized under existing statutes. It is involved in such diverse areas as import relief for domestic industries, the Generalized System of Preferences, East-West trade, unfair foreign trade practices and the conduct of international negotiations.

The ITC serves as an adviser to the president and as an information resource for the White House as well as Congress, the U.S. Trade Representative and other interested parties. It gathers information for investigations and reports through hearings, surveys, fieldwork and integration of data from a variety of government agencies. The commission's principal tasks include:

- Recommending to the president relief for industries seriously injured by increasing imports (investigations under Section 201 of the 1974 Trade Act).
- Determining whether U.S. industries are materially injured by imports priced below fair value or subsidized (antidumping and countervailing-duty investigations).
- Actions subject to presidential disapproval against unfair trade practices such as patent infringement and intellectual property violations (investigations under Section 337 of the 1930 Tariff Act).
- Advising the president on whether agricultural imports interfere with the Department of Agriculture's price-support programs.
- Preparing studies on trade and tariff issues on request or self-initiation; monitoring import levels.
- Developing uniform statistical data on imports, exports and domestic production as well as helping to establish an international commodity code.

How did the commission accumulate such a variety of duties? An examination of the ITC's development since its inception portrays the numerous changes the commission has seen over the years and presents a basis for understanding the nature of its current role in U.S. trade policy.

A History of Controversy

The ITC was first established as the U.S. Tariff Commission in 1916 under a mandate that in many ways remained unchanged for the following 70 years. The creation of an objective body to study the impact of tariffs on domestic and international trade grew out of industry and government dissatisfaction with the inflexible nature of tariff policy and the acknowledgement that the involvement of experts was required. The Tariff Commission was charged with preparing analyses of U.S. competitiveness, collecting information on world tariffs and trade regulations and -- its most controversial function -- investigating unfair trade practices, including unfairly priced imports. Frank W. Taussig, the first chairman of the agency, commented on its role in the development and administration of U.S. trade policy this way:

> . . . our task is not to take tariff questions out of the hands of Congress, or to remove them from the realm of statesmanship. We hope that we can aid in their settlement and can promote the ends of statesmanship. . . . Nobody, however expert, can settle, still less dictate, the position which the country shall take on controverted political and industrial questions. All that any administrative or investigating body can do is to contribute toward discriminating and intelligent discussion and action. (Quoted in Two Centuries of Tariffs by John M. Dobson)

But it was just this problem of whether or not the commission should "make policy" and the links between commission decisions and party politics that plagued its designated role from the start. Neither rules preventing either political party from holding a majority nor the installation of overlapping terms for the commissioners freed the commission from charges of partisan politics during its early years. When the "Democratic and free-trade attitudes" of the first members chosen by President Woodrow Wilson clashed with those of the conservative legislators brought to Washington in the election of 1918, a slash in funding and personnel shortages resulted.

By 1921 resignations and presidential appointments skewed the commission so that its reputation for independence and technical competence was seriously damaged. Its investigative functions were so impaired by the politically hogtied commissioners and the complicated administrative procedures detailed in the Fordney-McCumber Tariff Act of 1922 that by 1929 only five of 37 investigations initiated had been completed. Politicization was "so obvious" that a Senate committee investigated, and calls were made to abolish the Tariff Commission altogether.

However, by then the commission had developed rather sophisticated expertise in tariff information and data collection, and its reputation for thoroughness was valuable enough that Congress and President Herbert Hoover considered it worth preserving. Along with the overhaul of the tariff system in 1928-29, the commission was reorganized. The changes, incorporated in the infamous Smoot-Hawley Tariff Act of 1930, halved the commissioners' 12-year terms, dismissed all the sitting commissioners, and delineated the commission's duties in a form that is still largely intact today.

The focus on the Tariff Commission faded during the 1930s as the machinery of trade policy was based on reciprocal trade agreements rather than reworkings of U.S. tariff schedules, and Congress transfered most of the control over trade policy to the president. Although the agency's analytical and data-collection functions continued, its investigative activity slowed to a trickle. Moreover, until the end of World War II, the commissioners and their staffs participated at various levels of decisionmaking on trade agreements, including close involvement with the establishment of the General Agreement on Tariffs and Trade. The independence of the institution from executive agencies and policymaking activities seemed permanently undercut.

However, Congress' dislike for the Truman administration and its disillusionment with the prolonged trade agreements policy process prompted a trade administration overhaul in 1948 that, among other things, severed the Tariff Commission from the executive branch. The 1948 Trade Agreements Extension Act assigned the commission to investigate and rule on domestic industry's claims of injury under the so-called "escape clause" of the GATT, a task that took up a great deal of the commission's time and energies. The legislation also started a cycle of executive-legislative tussles over commission participation in executive branch decisions and disagreements over the president's discretion to initiate concessions in trade negotiations.

When the dust settled in 1951, the Tariff Commission had a more narrowly defined support role in international trade negotiations and had retained the authority to study all items proposed for tariff negotiations -- that is, to indicate the "peril point," or point to which tariff concessions could be offered without seriously injuring domestic industry. The commission's peril-point investigations were, in effect, a check on the president's ability to make tariff reductions that lasted until 1962.

For the Tariff Commission, the 1950s were years of acquiring various investigative tasks and a prelude to another major reworking of trade remedy procedures and tariff scheduling in the early 1960s. Along with peril-point and escape-clause investigations and reviews, there was a statutory change in 1954 ceding to the commission the import injury determination step in antidumping cases that was originally under the purview of the Treasury Department, and a 1951 revision of the Agricultural Adjustment Act that reinvigorated its activities under that statute.

The 1962 Trade Expansion Act revised trade remedy procedures and added adjustment assistance to the list of relief measures the commission could recommend in escape-clause cases. A mechanism by which Congress could override a presidential decision not to take escape-clause action was also provided. The 1962 act marked the commission's first involvement in adjustment cases; between 1962 and 1975, 331 worker and company adjustment assistance investigations were completed. Also included in the 1962 legislation was the task of reporting on the domestic economic impact of negotiated concessions, a provision almost identical to the peril-point investigation. In 1965 Congress added the task of monitoring the conditions of workers affected by the removal of tariffs on U.S. imports of motor vehicles and automotive parts manufactured in Canada.

The first half of the 1960s saw several efforts to review and revise tariff schedules and, because of its expertise in compiling technical data, this work fell to the commission. The result was the first annual publication of the Tariff Schedules of the United States in 1963. The commission was also deeply involved in the Kennedy Round of GATT multilateral trade negotiations in the role of technical adviser and data coordinator.

Off and on since first ceding investigatory functions to the commission in 1922, Congress has turned its attention to how actively the agency pursues injury investigations and how often it recommends relief. These concerns arose again when the tortuous language of the 1962 act made it difficult for the commission to determine injury under the adjustment assistance provisions. So many negative determinations were made during the 1960s that petitions for relief slowed and, in fact, the number of cases in all the various investigative categories decreased markedly. However, the pace picked up again in 1970 as the United States went through a recession and the Tariff Commission began to recommend relief more frequently. Petitions of all kinds skyrocketed, and yet another debate and revision of trade relief procedures began in Congress, culminating in the Trade Act of 1974.

Adjustments to Law Continue

The present system of trade remedy law is largely a result of the administrative and procedural overhaul instituted under the 1974 legislation. The Tariff Commission was renamed the International Trade Commission in view of its wide range of responsibilities -- both domestically with import surveys and trade and tariff information and internationally with examinations of U.S. exports and world trade conditions. Another attempt was made to guarantee the ITC's independence from the executive branch by transfering budgetary control of the commission to Congress, installing a rotating system for commission chairman selection, and lengthening the terms of the commissioners to nine years.

The 1974 Trade Act attempted to update and reorganize trade remedy statutes. In the process, the ITC's investigative functions were redefined and it was given several new areas of responsibility. Escape-clause investigations were encoded in Section 201 of the act, with new, somewhat simpler criteria for judging injury from imports. Rapidly rising imports had to be found to be a substantial cause of actual or potential serious injury to domestic industry in order for trade relief to be recommended. Moreover, provision was made for a review by the commission of the probable economic effects of extending, reducing or terminating that relief. Congress could also force the president to act in these cases. If a majority of commissioners voted for relief and the president rejected their position, Congress could override the president through a concurrent resolution and impose the ITC's recommendation.

The new legislation outlined exactly who could petition for relief under the statute and listed the kinds of relief the ITC could recommend -- higher tariffs, quotas, tariff-rate quotas or any combination of these were allowed. Worker and company adjustment assistance investigations were moved to other agencies, but the implications of labor displacement, although no longer explict, remained a criteria in the ITC's consideration of industrial health.

Investigative procedures for cases under Section 337 of the Tariff Act of 1930, usually regarding intellectual property and patent rights, were shortened and the investigative process "sharply altered" and given a more formal and judicial style. The commission was authorized to issue exclusion orders as well as cease and desist orders as necessary. The revised statute also ordered that factors other than just the domestic industry's health be taken into consideration when reviewing the potential effects of relief. Consumers, market conditions, general health and welfare, and the economy were among the explicit criteria listed.

Although investigations of foreign practices that impede U.S. exports under Section 301 of the 1974 act did not provide a role for the ITC, the president is able, under this legislation, to ask the ITC for an impact statement concerning domestic economic effects. Antidumping law was substantially revised by requiring a preliminary ITC ruling that there is a reasonable indication of injury from imports sold at less than fair value. Moreover, the

ITC was given the task of investigating market disruption caused by imports from Communist countries and monitoring and reporting on trade between the United States and nonmarket economies. Finally, the 1974 act reasserted the ITC's job of studying the economic effects of concessions in multilateral trade negotiations and the Generalized System of Preferences, and authorized it to play a role in the preparation of international trade negotiations under the GATT.

Still, dissatisfaction with the amount of relief afforded domestic industry continued, as did attempts to tinker with trade remedy laws. Largely in reaction to a split decision over non-rubber shoe imports, Congress amended Section 201 in 1976 to hold that a remedy suggested by a plurality rather than a majority of commissioners was adequate for the purpose of a congressional override of presidential inaction.

ITC findings of injury in the first 201 cases after 1974 had given rise to criticism that the agency had become substantially more protectionist in its newest incarnation. Others judged the escape-clause process to be as difficult as it ever was for an industry requesting relief. Clearly, the commission's record on 201 cases in the past 11 years has been mixed at best: the ITC has recommended relief in 32 of 55 cases completed since 1975. The perception that Section 201 was ineffective may be more easily traced to presidential reluctance to invoke the ITC's recommendations -- the White House granted relief to industry in only 18 of the 55 cases completed. Interestingly, executive branch decisions to ignore ITC remedies did not imply that the organization had less work to do. Confidence in the ITC's expertise as an industry assessor remained so high that the commission was assigned a role monitoring the steel import relief program instituted in late 1984 by President Reagan as an alternative to ITC quota recommendations.

In 1979, Congress focused on the antidumping and countervailing-duty laws, making a number of technical revisions and providing judicial review for such decisions. A major new job for the commission was the task of reviewing effects on domestic industry of a revocation of countervailing-duty orders issued before 1980.

The administration was preoccupied with its twin goals of renewing the GSP system and getting approval for a free-trade arrangement with Israel when work began on what was to become the Trade and Tariff Act of 1984. But Congress was interested in reinvigorating the trade remedy statutes, especially Section 201, since petition levels had dropped to only one or two cases a year after the December 1980 negative determination on car imports. Members also attempted to expand the definition of unfair trade practices and include natural resource subsidies under the antidumping and countervailing-duty laws -- ideas that still take up a large part of the trade reform debate today. But by and large, these proposals were thrown out during the conference committee process.

What remained were congressional instructions that the ITC take into account economic factors like plant closings and other structural disturbances in its 201 injury considerations. Adjustment assistance was added once again to the list of 201 relief remedies and, as a result of a Supreme Court ruling on legislative vetoes, a joint rather than a concurrent resolution allowed

Congress to override the president's refusal to bestow 201 relief. Moreover, the new law established a Trade Remedy Assistance Office in the ITC to help industry, particularly small businesses, wade through the complicated procedures for filing relief petitions.

The antidumping and countervailing-duty revisions, mostly technical, included a clarification of the factors to be considered when making a determination on the threat of material injury posed by unfairly priced imports. It also required the commission, in cases where an import from several different countries is affecting domestic industry, to consider the cumulative impact when determining injury. Finally, the 1984 legislation attempted to expand the definition of "subsidy" to include so-called "upstream subsidies," or subsidies of inputs in the production process.

The soaring dollar and the accompanying surge in imports has indeed brought another cycle of relief requests. Between 1981 and 1984 the ITC workload grew by 88 percent, mostly through a sharp rise in antidumping and countervailing-duty petitions. The ITC has become busier than ever, devoting an increasingly large share of its time to investigations rather than to other duties. Chairwoman Paula Stern likens the institution to "a 'M*A*S*H unit for the wounded in the ongoing trade battles," or a "cop on the import beat." Not surprisingly, discussion has been renewed among those in the trade field on how to improve trade remedy laws and how to make the best use of the ITC.

The Politics of Trade Law Administration

Chairwoman Stern has explained the method the United States has developed for handling trade problems as being essentially made up of two structures:

> The first is the rule-oriented approach, of which my agency, the U.S. International Trade Commission, is a prime example. Here problems are resolved within the framework of legal standards. The second structure utilizes the political system. Relief can be sought either in Congress or the executive branch. . . . Our statutory framework for dealing with import relief requests blends these two structures effectively. (Address to Swedish Wholesalers, Stockholm, Sweden, March 25, 1985)

There are political angles to the ITC, however, although the agency continues to pride itself on its independence and objectivity. These are best viewed in three instances: the impact of the organization and its processes on U.S. relations with other nations; the external and internal political pressures brought to bear on the procedures the ITC administers; and the political stance of the commissioners themselves.

The ITC's job on paper seems essentially legalistic and far removed from the active debate and management of relations between nations. But putting trade law into practice can have an impact on bilateral affairs. A case in point is the ITC's involvement with Japan. More antidumping and countervailing-duty orders are in effect against Japan than any other country -- 35 by the end of 1984. The first industrial targeting study taken on by the commission was a case study of Japanese practices. During FY 1985 the ITC investigated or reviewed cases involving about a dozen Japanese products, mostly under the antidumping and countervailing-duty statutes.

This does not mean that the ITC is out to "get" Japan: the commission is better viewed as an indicator of the degree of U.S. business and government concern. However, the number of cases and intense media coverage of bilateral developments add substance to the perception that trading relations between the two countries are in sorry shape.

Moreover, the ITC is not simply a passive body that tests injury claims. It is also the instrument that recommends and, in some cases, delivers the slap on the hand. Finally, it functions as a forum for strategic moves by opposing sides. The ITC has an impact on the conduct of U.S.-Japan relations as any review of the steel and auto cases of the late 1970s indicates. More recently, ITC injury rulings on cellular mobile telephones and preliminary judgments on semiconductors added urgency to the bilateral negotiations conducted between the two countries last year.

The battle over semiconductors will continue to be influenced by ITC final injury decisions scheduled later this year in the antidumping cases against Japanese-made EPROMs (erasable, programmable read-only memories), 64K DRAMs (dynamic random access memories) and 256K DRAMs. Preliminary findings of injury in these three investigations have provoked more efforts by Tokyo to settle the question "out of court," as it were. Japanese industry representatives realize that once the ITC makes its final determination, the only recourse is appeal to the U.S. Court of International Trade, and this judicial body rarely overturns an ITC decision.

At home, as is evident by the ITC's rather turbulent institutional history, the struggle between the executive and legislative branches to manage trade policy has resulted in constant review and revision of the ITC's roles and missions. The process that has elicited the closest examination and the most political controversy is Section 201. Here, the ITC can be viewed as a pressure valve for protectionist sentiments, or as an implementor of complex "procedural protectionism" as designed by Congress. Either way, it is caught in the middle. And in the elaborate procedure the United States has constructed to comply with fairly straightforward GATT provisions on safeguards, there is room for political pressures from domestic petitioners, foreign governments, and the executive and legislative branches.

As pointed out earlier, the ITC conducts a "rule-oriented investigation" and is restricted to recommending certain specific remedies. The three criteria the commissioners must employ in a 201 proceeding are a determination of an increase in imports; a finding that the domestic industry in question has been seriously injured or threatened with serious injury; and a determination that the increase in imports is a cause of the industry's serious injury that is as important as any other cause. The ITC then recommends relief from a discrete list of options elucidated in the statute. The president, with an eye to larger political and economic policy concerns, makes the final decision to bestow relief, and has the discretion to disregard or modify the ITC recommendation or to institute relief of any kind he deems appropriate.

But political considerations start well before this final decision stage. The decision to submit a petition for action is one example. Observers point out that since Section 201 was instituted there have been surges in the number of relief requests during election years (see Table). There is little disagreement over why this occurs. Industry representatives feel that the pressures of election-year politics affect legislators that are already sensitive to the effects of imports on unemployment and potential "deindustrialization," and make it more difficult for the president to ignore an ITC recommendation for relief.

Selected ITC Investigations Completed, FY 1975-85

Fiscal Year	Section 201 Investigations	Antidumping and Countervailing-Duty Investigations
1975	--	6
1976	14	19
1977	12	11
1978	9	35
1979	3	33
1980	5	108
1981	1	49
1982	2	179
1983	2	129
1984	5	117
1985	2	185
Total	55*	871

*ITC recommended relief in 32 cases. President granted remedies in 18 cases.

Source: U.S. International Trade Commission, Annual Reports.

Similarly, the degree of political support an industry can muster from legislators, labor unions and the White House is a major consideration for strategists planning a 201 petition. Steel and textiles have always had tremendous political clout -- wringing concessions from successive administrations no matter how adamantly they promote a hands-off business policy. Footwear, on the other hand, has had considerably less success.

How much the political turmoil over industrial relief affects the ITC's consideration of the case is an open question. One long-time trade policy observer suggests that in some votes the commissioners are looking over their shoulders to Capitol Hill, particularly in the direction of the Senate Finance and House Ways and Means Committees, which hold sway not only over the ITC's funding but trade law reform proposals as well. An example frequently cited of this kind of political sensitivity is non-rubber footwear. The commissioners turned down industry requests for relief twice before finding in the affirmative in July 1985. Sources inside the ITC insist that the criteria by which injury is judged changed substantially and necessitated a turnaround.

Other observers are less sure. They point out that the commissioners are independent, with very little guidance on how to evaluate statutes and the leeway to interpret the injury formula rigidly or liberally. According to this reasoning, the commissioners must have realized another negative finding would have ignited congressional demands for protectionism (a development that occurred anyway when the president decided to disregard the ITC's recommendation). The commissioners may have been further sensitized by the frequent statutorial reprimands they received from Congress. The provision of the 1984 Trade Act instructing the ITC to consider plant closings and employment trends in its analysis was aimed at the agency's decision to recommend against relief for footwear firms in 1984.

But insiders deny that political weights and balances entered into the 1985 footwear decision. Although they admit that the commissioners were aware of some political fallout and knew that an affirmative decision, if rejected by the president, would put the White House in a confrontation with Congress, the commissioners issued the injury ruling based on the facts.

Even critics give the ITC consistently high marks for its professionalism, the quality of its staffing, and its determination to make legally sound judgments that cannot be construed as arbitrary or capricious. Still, there is disagreement over whether or not its procedures are politically tainted. A Washington attorney who represents U.S. industry says, "We think long and hard whether politics should enter into the case we present." Caution is necessary, he adds, because some lawyers feel that introducing political pressure into an ITC decision is as likely to cause a negative reaction among the commissioners as a positive one.

"They're impartial as judges," asserts a lawyer representing foreign interests. "They're not blatently political, but one can find votes that seem ideological or political. By and large they do their job sincerely." Still, he views the commissioners as accessible for lobbying purposes and thinks there is considerable room for maneuver in all stages of the elaborate trade policymaking machinery.

Recent commissioners have, for the most part, been successful in preserving the ITC's longstanding reputation for fair and impartial judgments. Although each has an extensive background in legal and economic affairs, their individual voting records do not indicate slavish devotion to any particular philosophy, especially in free-market versus protectionist terms. It is easy to see some correlation between increases in injury findings and legislatively dictated liberalization of the use of Section 201. It is not so easy to distinguish a relationship between party affiliation/administration loyalty and the commissioners' voting habits.

But for those willing to try to divine how the panel votes, there are a number of clues available in the form of chairwoman Paula Stern's speeches. Ms. Stern has firm ideas and an activist stance on the need for exchange rate intervention, government support for structural adjustment programs and antitrust revision. She has put the blame for the burgeoning U.S. trade deficit squarely on the strength of the dollar, and openly criticized the Reagan administration for its lack of a coordinated trade strategy to combat the situation.

She also has confidence that the ITC is useful and would like to see its role enhanced. "My own commission has acquired great expertise in assessing the strengths and weaknesses of many industries. That information is valuable only if it is used. It rarely is," she complained during an appearance last fall. In an interview published in the Washington Post, Ms. Stern was not shy about her part in the ongoing controversy over trade policy, stating that she has set out to "influence the debate in any way I can."

These statements are viewed as an embarassment by many of the other commissioners, according to ITC sources. Any kind of involvement in policy-making is well outside the scope of the ITC's traditional mission and a commissioner's authority. It is their fear that when doubts are cast about the independence of the ITC, the commission could be only a few steps away from losing its reputation for impartiality.

But Ms. Stern's activities are viewed more kindly by others. "She doesn't go that far," maintains one observer, "she's just one of the chorus." Many agree that Ms. Stern's comments represent one line of mainstream criticism. They also believe that it does not reflect on her work with the commission, pointing out that despite her high profile, she wields only one vote out of six and her votes are impossible to peg politically. For them, her experience examining the health of U.S. industry and measuring the impact of imports qualifies her, as well as the other commissioners, to participate in the trade debate.

A More Generous Slice of the Policy Pie?

Of all the issues facing the ITC as it approaches its eighth decade, the problem of an expanding mandate takes precedence. The specter of more duties and more control over trade remedy assistance has arisen largely because of the new political strength that trade issues have acquired and the laggard, and what some call ineffective, manner in which decisions on trade are reached by the executive branch.

Despite some distant rumblings about politics, the ITC's legal judgments, investigations and reports are universely lauded as comprehensive and fair. When proposals to revise trade laws are being written, according to one Hill staffer, the suggestion is often made to let the ITC handle it. And not only in matters related to import relief; Congress is distrustful of and impatient for reports by the executive agencies and is turning increasingly to the commission for updated information. This trend shows every sign of increasing, leading some to observe that the ITC seems to be filling the vacuum that better interagency coordination, or even a Department of Trade would fill. The commission seems to be sliding, albeit quite subtly, into an active policy role.

Can the institution cope with a workload that continues to increase and develop the expertise needed to answer Congress' questions? Many think so. Although its "plate is full," by all accounts the ITC gets the work done and, remarkably, almost always on time. If the commission needs to increase its budget in order to meet growing demands, ITC employees are confident they will get what they ask for from Congress. Similarly, they are convinced that they can beat back any proposals to shorten what are already very tight investigative schedules. As for new functions, when the agency was handed the task of examining foreign industrial targeting, it produced reports that trade analysts consider to be of the highest quality.

Despite these upbeat feelings about the agency's product, not a few question whether the ITC *should* develop in new directions, particularly in functional terms. Evaluation of overseas industries and foreign export policies, such as the industrial targeting study, is one case. The ITC is required by statute to consider production activities abroad as well as foreign export policies and import trends. Yet it cannot send people overseas to examine company books, mail out questionnaires or otherwise develop the solid data base it needs for this type of inquiry in the same way it gathers information domestically. The commission is unlikely to settle for these limitations for long and for this reason an overhaul of its analytic perspective is imminent. "The ITC is more comfortable with a mercantile view, but it is developing a perspective to look at things globally," says one trade analyst. "The development of an export orientation is inevitable."

There are short-term changes in the offing as well, stemming from the sweeping debate over trade that intensified last year. Virtually all the trade proposals on Capitol Hill contain provisions that would considerably alter the trade law *status quo*. ITC insiders indicate concern about several reform issues. A new focus on adjustment programs has given rise to suggestions that the ITC should be given the responsibility of sitting down with management and labor and working out industrial restructuring programs. A major element in this debate is conditionality, that is, the concept that to be eligible for relief an industry must commit to change and solve such problems as high cost and low productivity. "Adjustment smacks of industrial policy," says one long-time policy observer. "It is more difficult in practice than it appears in theory."

This complicated task has been endorsed by chairwoman Stern, who maintains that in view of the country's many attempts to find a responsive import relief system, "more finely tuned instruments to promote adjustment are needed." The ITC, with its expertise on problems confronting manufacturing industries is well suited to this work, she believes. Others, however, are dubious about the agency's ability to fashion trade remedies. "[The Congress] thinks a little more highly of us than our capabilities," an ITC source says sheepishly.

Another popular notion for escape-clause revision concerns limits on or an outright end to the president's ability to impose or withhold ITC-recommended relief. The issue of presidential discretion may prove to be one of the most volatile of the upcoming legislative debates, hinging as it does on congressional confidence in the president's ability to establish and implement effective policy. With the president's authority held in check, as well as a greatly expanded set of relief options included in many proposals, the commission's power over the ultimate direction of the relief process would increase. "The removal of the president's discretion in 201 puts us in a bit of a policy role in historical terms," admits one source.

The policy role question is an irksome one to those in the ITC who recall the agency's past problems and see the commission encroaching on executive branch territory once again. Still, everyone realizes that both in theory and in practice the quasi-judicial, policy-neutral mandate has been difficult to maintain. The commissioners and their staffs frequently testify at congressional hearings on almost every element of trade policy implementation. The strain of refraining from comments on policymaking is always evident. For example, Congress regularly asks executive agencies to comment on proposed legislation. Rather than passing judgment, the ITC files a factual report and technical reading of the proposed statute. Even if a proposal directly concerns the workings of the commission, ITC representatives may explain the intricacies of trade law and implementation; they can explain the difficulties and ask for guidance, but they must not recommend solutions that can be construed as new policy.

A former ITC employee recalls the difficulties he had wearing his "ITC hat" during strategy sessions between executive agencies participating in multilateral trade negotiations. He had to constantly remind himself that his was a non-policy mandate -- that although he naturally was influencing policy by offering technical advice, he could not initiate a policy decision. Some trade analysts consider convoluted attempts to stay "pure" pointless, and label the ITC's attempts to dissociate itself from the decisionmaking process foolish. "Of course they're in the policy process," says a trade lawyer. "They have tremendous impact on policy in terms of analysis and the issues."

Conclusion

The ITC today is, as institutional historian John M. Dobson has stated, the culmination of seven decades of thought and reconsideration. Current developments seem remarkably consistent with previous historical debates. There is a certain continuity in the leitmotif of struggle between the president and Congress over control of trade policy. The ITC as an independent agency is caught in the middle, its institutional outlines buffeted by demands from both sides.

The politicization of trade and questions about the benefits of foreign competition are also consistent themes. Every new look at the state of international trade results in tinkering with trade remedy laws and the augmentation of an already complex, hydra-headed process. The ITC, as implementor, must cope with legislative whims created by politics as much as by economics, divine congressional intent and, from ambiguous and archaic language, render sound legal judgments.

This makes it even more amazing that the commission's work is so highly regarded by both participants and observers. Because of its impartiality and technical expertise, the agency is gradually assuming greater responsibilities. The possibility of its crossing openly into the policy arena seems inevitable. If the ITC is indeed a "trade cop," it is a much decorated one that might be aspiring to public office.

For further information, contact Sheri Hoptman.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix: The ITC's Evolving Roles and Missions

September 8, 1916 - Establishment of the U.S. Tariff Commission.

Fordney-McCumber Tariff Act of 1922 - Tariff Commission given investigative duties over flexible-tariff cases, unfair trade practices and discrimination.

Smoot-Hawley Tariff Act of 1930 - Tariff Commission reorganization; flexible-tariff tasks increased.

Amendment to the Agricultural Adjustment Act, 1935 - Tariff Commission given investigative authority over agricultural imports thought to be interfering with government price-maintenance programs.

Trade Agreements Extension Act of 1948 - Tariff Commission assigned to investigate and rule on escape-clause cases; commissioners and staff explicitly excluded from negotiation and policy formulation processes; investigation of the effects of proposed negotiating concessions on domestic industry added ("peril-point" investigations).

Trade Agreements Extension Act of 1949 - "Peril-point" provision repealed; Tariff Commission participation in interdepartmental trade committee meetings allowed.

Trade Agreements Extension Act of 1951 - "Peril-point" provision restored; the president must justify his decision to disregard the Tariff Commission's findings of potential harm through the "peril-point" process; statutory procedures for escape-clause investigations outlined.

Tariff Classification Act of 1962 - Tariff Commission ordered to prepare Tariff Schedules of the United States.

Trade Expansion Act of 1962 - Tariff Commission given reporting authority over economic effects of negotiated concessions; injury-determining criteria restricted; adjustment assistance remedy added.

Trade Act of 1974 - Tariff Commission reorganized as the International Trade Commission. Expanded mandate included task of preparing statements on the probable economic effects of trade negotiations and the Generalized System of Preferences, participating in new trade relief processes, and monitoring and reporting on East-West trade relations. Procedural changes in Section 337 investigations included authority to issue cease and desist orders and shorter time limits on cases. Greater independence from the executive branch through the budgetary process and commissioner appointment system were added.

Tax Code Reform, Amendment, 1976 - Provision added to provide that a vote by a plurality of commissioners for a particular remedy in 201 cases that the president chooses to disregard can be the basis for a congressional override in the form of a concurrent resolution.

Trade Agreements Act of 1979 - Injury test installed in countervailing-duty process; review provided for reviewing outstanding countervailing-duty orders;

antidumping and countervailing-duty technical revisions; judicial review instituted.

Trade and Tariff Act of 1984 - Scope for injury findings in antidumping and countervailing-duty cases expanded to include threat from potential imports as well as actual imports; ITC directed to consider the cumulative effects of imports originating in several countries; definition of subsidy in countervailing-duty statute expanded to include "upstream subsidies"; additional economic factors like plant closings added to criteria for injury in 201 cases; congressional override authority form changed from concurrent to joint resolution.

Source: U.S. International Trade Commission

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Yen Gets Second Wind Against The Dollar

On February 10 the yen rose to its highest level since November 1978, closing at Y189.9=$1.00. After eight days of consecutive increases, its momentum had been broken briefly by Bank of Japan governor Satoshi Sumita's February 3 statement that the yen was rising too rapidly against the dollar. But the yen resumed its appreciation relative to the dollar following President Reagan's remarks on exchange rates in the State of the Union address. His statement that economic growth requires "reliable" exchange rates was perceived as a call for a further decline in the dollar.

STATISTICAL SUPPLEMENT

Trade and Payments Data

(in millions of dollars unless otherwise indicated)

	1983	1984	January-December 1984	January-December 1985	October 1985	November 1985	December 1985
Japan's Balance of Payments							
Trade Balance	$31,454	$44,257	$44,257	$56,002*	$5,401*	$5,349*	$7,045*
Exports (f.o.b.)	145,468	168,290	168,290	173,928*	15,992*	15,322*	17,742*
Imports (f.o.b.)	114,014	124,033	124,033	117,926*	10,591*	9,973*	10,697*
Current Account Balance	20,799	35,003	35,003	49,271*	4,773*	4,518*	6,805*
Long-Term Capital (net)	-17,700	-49,651	-49,651	-64,807*	-7,226*	-5,639*	-6,112*
Overall Balance	5,177	-15,200	-15,200	-12,318	-2,606	-290	-337
International Reserves (end of period)	24,496	26,313	26,313	26,510	26,372	26,303	26,510
Japan's Customs Clearance Trade							
Trade Balance	20,534	33,611	33,611	46,142*	4,359	4,779	6,643*
Exports (f.o.b.)	146,928	170,114	170,114	175,644*	16,035	15,485	17,927*
Cars	19,535	21,899	21,899	25,416*	2,471	2,577	2,523*
Steel	12,843	13,852	13,852	13,568*	1,086	1,048	1,411*
Imports (c.i.f.)	126,393	136,503	136,503	129,503*	11,675	10,706	11,284*
Crude Oil	40,063	39,379	39,379	34,601*	2,991	2,687	3,547*
Japan-U.S. Trade							
Trade Balance	18,181	33,075	33,075	39,511*	3,685	4,030	4,498*
Exports (f.o.b.)	42,829	59,937	59,937	65,290*	6,039	6,059	6,372*
Imports (c.i.f.)	24,648	26,862	26,862	25,779*	2,354	2,029	1,873*
Yen-Dollar Exchange Rate							
Tokyo Spot Market (end of period)	Y232.20	Y251.10	---	---	Y211.50	Y202.00	Y200.50
U.S.-Japan Trade							
Trade Balance	-19,289	-33,560	-33,560	-46,152	-3,403	-4,071	-4,461
Exports (f.a.s.)	21,894	23,575	23,575	22,631	1,834	1,972	1,761
Industrial Supplies	8,734	9,139	9,139	8,680	658	775	779
Food and Feed	5,555	5,929	5,929	5,001	431	420	377
Capital Goods	5,116	5,627	5,627	5,939	522	554	373
Consumer Goods	1,394	1,476	1,476	1,416	114	106	102
Imports (Customs)	41,183	57,135	57,135	68,783	5,237	6,043	6,222
Automotive Products	14,919	18,477	18,477	24,980	1,804	2,374	2,605
Capital Goods	11,896	19,290	19,290	21,516	1,667	1,761	1,774
Consumer Goods	8,296	11,266	11,266	14,017	1,196	1,269	1,189
Industrial Supplies	5,391	7,276	7,276	7,035	462	525	545

*Preliminary

Japanese Economic Indicators

(percentage change from year-earlier period unless otherwise indicated)

	1983	1984	January-December 1984	January-December 1985	October 1985	November 1985	December 1985
Discount Rate (end of period)	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Outstanding Money Supply	7.4%	7.8%	7.8%	8.4%*	8.6%	9.1%	9.3%*
Industrial Production	3.6%	11.1%	11.1%	4.6%*	1.6%	0.4%	1.7%*
Manufacturing Operating Rate	1.6%	7.3%	7.8%**	1.4%**	0.6%	-2.0%	n.a.
Number of Bankruptcies	11.9%	8.8%	8.8%	-9.7%	-6.6%	-11.6%	-15.2%
Residential Construction Starts	-0.8%	4.4%	4.4%	4.1%*	5.4%	6.5%	5.3%*
Job Openings to Applications (ratio)	0.60	0.65	0.65	0.68	0.67	0.67	0.67
Nominal Wages	3.5%	4.5%	4.5%	3.8%	3.6%	3.9%	3.2%
Labor Productivity	4.5%	9.9%	10.5%***	5.2%***	n.a.	n.a.	n.a.
Wholesale Prices	-2.2%	-0.3%	-0.3%	-1.1%	-3.2%	-3.8%	-4.2%
Consumer Prices	1.9%	2.2%	2.2%	2.1%	2.3%	1.9%	1.8%
Yen-Based Export Prices	-6.0%	0.6%	0.6%	-1.4%	-8.0%	-9.7%	-10.7%
Yen-Based Import Prices	-7.8%	-3.4%	-3.4%	-2.5%	-9.2%	-11.1%	-12.2%

*Preliminary

**Through November of each year only.

***Through September of each year only.

For Japan's most recent GNP figures, see JEI Report No. 48B, December 20, 1985.

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LIVING WITH THE TRADE DEFICIT: ADJUSTMENT STRATEGIES TO PRESERVE FREE TRADE

A STUDY BY ROBERT Z. LAWRENCE AND ROBERT E. LITAN
OF THE BROOKINGS INSTITUTION*

Summary

Washington's track record in devising policies to help American manufacturers and workers hard hit by imports adapt to the new conditions of competition is mixed at best. More often than not, these programs end up delaying adjustment rather than facilitating it. With foreign competition squeezing operations in a lengthening list of U.S. industries, there is an immediate need for effective government policies to ease the economic dislocations caused by trade. In the following article, Robert Z. Lawrence and Robert E. Litan, senior fellows in the Economic Studies program at The Brookings Institution, propose one such strategy, a combination of four years of declining tariff relief for industries found to be hurt by imports and automatic adjustment assistance for workers displaced by imports.

Introduction

Supporters of free trade are on the defensive. A rising trade deficit -- threatening to top $150 billion this year [1985] -- and sluggish economic growth have encouraged the introduction of more than 300 bills in Congress to restrict access by foreign goods to the U.S. market. Unless the trade gap

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narrows, the prospects are good that some type of protectionist legislation will be enacted before the 1986 mid-term congressional elections.

Most economists decry this apparent drift toward protectionism. They tirelessly point out that the primary reason for the high and rising trade deficit is the succession of record federal budget deficits, not the barriers to trade maintained by other nations (see box). After all, they reason, the trading system is no more unfair to the United States today than it was in 1981 when the United States enjoyed a positive trade balance in manufactured goods.

At the same time, however, there is growing concern among both politicians and economists about the long-range implications of the current trade imbalance. Last spring, the United States became a net debtor nation for the first time since 1941, largely as a result of unprecedentedly high borrowing from foreign creditors who help to finance the growing trade deficit. Continued increases in debt owed to foreign nations will ultimately be paid for by sacrifices in future living standards, through shipments to foreign purchasers of U.S.-produced goods that American consumers would otherwise enjoy. If this debt repayment is attended by a substantial depreciation of the dollar -- which many economists believe is inevitable -- the cost of imported goods will climb and the rate of inflation will increase.

Erecting trade barriers here, either as bargaining chips or as purely protectionist devices, would only make matters worse. Added trade restrictions would strengthen the dollar and reduce the competitiveness of American goods in world markets. Also, a turn toward protectionism by the United States could trigger retaliation by other countries, leaving all trading nations worse off, as occurred in the 1930s after the United States passed the infamous Smoot-Hawley Tariff Act. Finally, curtailing imports from countries now heavily in debt, such as Brazil and South Korea, could strain the American banks to which this debt is owed and threaten the viability of an already fragile financial system.

Many of the new congressional advocates of protection are cognizant of its dangers, but argue that protectionist measures are needed to close the worsening trade gap. One cynical explanation is that lawmakers are using the growing trade deficit to make foreign countries the scapegoats for the recent hiatus in the U.S. economic recovery. A more compelling explanation is that lashing out at foreign trade barriers can be more attractive politically than tackling the complex and divisive task of reducing the principal cause of the current trade imbalance: the federal budget deficit, which most forecasters outside the administration expect to exceed $100 billion a year through the end of the decade.

In such an environment, repeated calls by economists, the news media, and other opinion leaders for budget discipline as a means of paring the trade deficit are likely to fall on deaf ears in Congress, which is pressured continually by workers and firms in trade-sensitive sectors of the economy that have been battered by the strong dollar. To be sure, the dollar has weakened somewhat in the wake of the Treasury Department's recent commitment to intervene with the finance ministries of Japan, England, France and West Germany in

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The Link Between Federal Budget Deficits and Trade Deficits

The U.S. current account -- the net balance of exports and imports of goods and services -- can be directly linked to the U.S. budget deficit. This is because the current account balance is, by definition, equal to the difference between national saving and national investment. At any given level of employment, if the government seeks to increase its consumption, either the private sector will have to consume less or the goods will have to be obtained from abroad. Thus, given private investment and savings behavior, an increase in the government deficit will translate, dollar for dollar, into a decline in the current account balance. This means the size of the current account balance is not so much an indicator of a nation's competitiveness as it is of the nation's spending behavior.

These principles can be derived algebraically from the deiinitons of Gross National Product (GNP) and Gross National Income (GNI), which must be identical. GNP is the sum of Private Consumption (C), Private Investment (I), Government Spending (G), Exports of Goods and Services (X), minus Imports of Goods and Services (M), or

$$GNP = C + I + G + X - M.$$

GNI, meanwhile, equals the sum of Private Consumption (C), Private Saving (S), and Tax Revenues of the Government (T), or

$$GNI = C + S + T.$$

Since GNP must equal GNI, the above two identities can be set equal to each other, as follows:

$$C + S + T = C + I + G + X - M.$$

After subtracting C from each side, these terms can be rearranged into the following fundamental identity:

$$(S - I) + (T - G) = X - M,$$

or Net Private Saving + Net Government Saving = Current Account Balance.

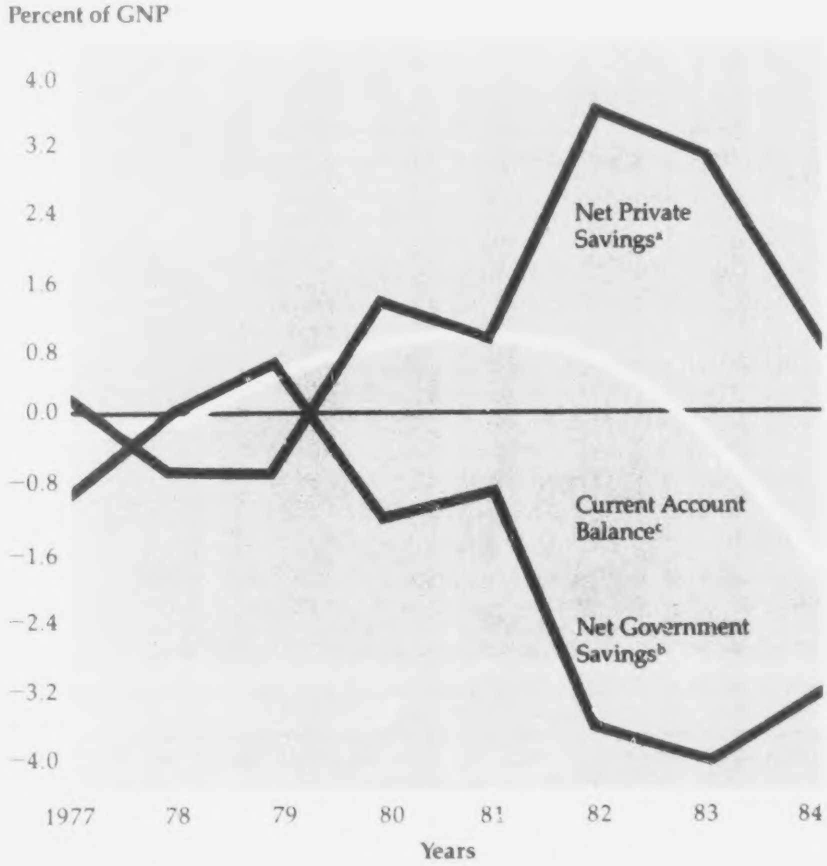
In short, the current account balance equals the sum of net private and government saving. Figure 1 shows what has happened to each of the components of this identity since 1977. Significantly, the current account balance began to turn negative as the total government deficit (dissaving) began to rise. The current account balance has deteriorated most sharply since 1982, when net private saving dropped precipitously and the total government deficit was then exceeding 3 percent of GNP.

foreign exchange markets. In addition, the political momentum behind protectionism abated somewhat following the administration's announcement of its intention to step up enforcement of the laws against unfair trade practices. Nevertheless, the political impulses to embrace protectionist remedies remain strong. They will continue to push the administration away from policies favoring freer trade; even more dangerously, they could lead to concrete protectionist actions should U.S. economic growth continue to stall or the economy slide into recession.

Rather than acceding to protectionism, lawmakers should develop effective policies for easing the dislocations induced by trade. Politicians continue to face pressures for protectionism from firms, workers, and communities adversely affected by import competition; lawmakers can and will find it difficult to resist calls for trade barriers if they cannot point to policies that mitigate the economic pain caused by changes in trade patterns. Put in economic terms, aid for trade-injured parties can reduce both the demands for protection and the willingness of elected leaders to supply it.

The United States has attempted in the past to provide such assistance, but with mixed success. We believe that the nation can do better, but only if programs are designed to promote, rather than delay, adjustment to change. The cruelest form of aid is one that, in the end, leaves recipients in even worse shape to deal with the harsh competitive realities of the global marketplace. The danger of this outcome can be reduced if trade assistance programs meet the following criteria:

Figure 1.
Savings and Current Account Balances as Percent of GNP, 1977–84



[a] Equals gross private saving minus gross private investment, as percent of GNP.

[b] Equals total revenues minus expenditures of all governments (federal, state, and local), as percent of GNP.

[c] Equals exports, minus imports (goods and services), as percent of GNP.

-- Assistance must be temporary, so that it does not encourage dependence.

-- Assistance must be transparent, so that voters and politicians are aware of its costs.

-- Assistance must complement, rather than replace, market forces.

Below we present several detailed proposals based on these criteria. In part, our suggestions envision a fundamental redirection of two programs already in place: the temporary protection available through the current U.S. "escape clause" law and the help provided to some workers under the trade adjustment assistance program. Under our proposals, two types of aid would be triggered by an International Trade Commission (ITC) determination that an industry is suffering serious injury because of import competition. First, firms in the industry would be eligible for temporary protection from imports in the form of tariffs, but not quotas. Mergers of such firms would be judged under antitrust standards that recognize global competition. Second, workers in the industry would be eligible automatically for payments geared to their losses in income and for loans to finance retraining, with repayments based on future income and collected through the income tax system. We conclude by outlining a novel plan, not tied to ITC determinations, for enabling communities to insure against sudden losses in their tax bases due to trade-related or other economic dislocations.

Assisting Adjustment by Industry

Special assistance programs for industries adversely affected by import competition are considered justified on economic grounds in two circumstances. First, when changes in trade patterns reflect fundamental shifts in comparative advantage, targeted industry assistance can cushion the economic pain suffered by firms, their workers, and the communities in which they are located. Second, when a sudden surge of import competition is due to temporary factors, industry aid can prevent or minimize unnecessary losses in physical and human capital. For example, a nation may have a long-run comparative advantage in producing high-quality shoes or clothing. However, due to sudden relaxations in trade barriers or movements in exchange rates, its footwear and clothing industries may be temporarily unable to compete effectively with foreign producers. Without some short-term assistance to tide them over, firms in these industries can be severely and permanently damaged, large capital investments destroyed, and a trained labor pool lost forever.

The Current Assistance Program - In recognition of the potential value of assistance in the above circumstances, the United States and other nations allow temporary protection of domestic industries. The General Agreement on Tariffs and Trade (GATT), currently signed by over 80 nations, permits member countries to "escape" temporarily from tariff concessions and other obligations under the agreement if, as a result of such concessions, imports threaten or cause serious injury to domestic producers.

The U.S. escape clause law, set forth in sections 201 through 203 of the Trade Act of 1974, allows relief for up to five years if domestic industries can demonstrate to the ITC that they face serious harm from import competition.

(This law is more liberal than the GATT because it permits temporary protection even if the harm to the domestic industry is not a result of the removal of trade barriers under the GATT.) Import protection is not automatic, however. Even when the ITC finds the requisite serious injury, the president has substantial discretion. He may impose tariffs or quotas; negotiate orderly marketing agreements (OMAs), which are in effect bilateral quotas; recommend expeditious consideration of worker requests for adjustment assistance; or grant no relief at all.

The principal advantage of the escape clause is that it establishes an administrative mechanism that removes pleas for protection from the domain of elected officials. The clause has been fairly successful at keeping protection temporary. Of the 30 industries that have received protection in Section 201 cases since 1950, only two -- motorcycles and specialty steel -- remain protected today. By contrast, protections obtained directly from the Congress or through country-to-country agreements (as in the case of quotas for imports of textiles, beef, and sugar) have as a practical matter been permanent. Indeed, it is unfortunate that Congress has not required the ITC to provide regular reports on the impacts of the measures on consumers, firms, and workers. Such reports would at least expose to public view the costs and benefits of continued protectionism -- and Congress should provide for them if it decides to give permanent quota protection to the textile, footwear, and other domestic industries.

Criticisms of the Current System and Some Proposals for Change - The escape clause mechanism, however, is an imperfect method for assisting adjustments by trade-injured firms. Experience with other kinds of trade restraint suggests that protectionism, even if it is temporary, is expensive because it raises prices of all products -- both foreign and domestic -- in a protected market. Susan Hickok of the Federal Reserve Bank of New York estimates that current U.S. trade barriers are costing consumers at least $14 billion per year. Our colleague, Robert Crandall, has calculated that one barrier -- the so-called "Voluntary Restraint Agreement" that limited exports of Japanese automobiles to the United States -- alone cost American consumers over $4 billion annually in high prices [see JEI Report No. 46A, December 7, 1984], until the arrangement was allowed to expire earlier this year. According to Crandall, the cost per job saved in the automobile industry was $160,000 per year -- more than four times the average annual compensation of auto workers!

Not surprisingly, therefore, most economists urge that if trade-related assistance is to be provided at all to industry, it take the form of direct subsidies. In principle, subsidies are more efficient than tariffs or quotas because they do not distort the relative prices of goods and, therefore, do not disturb consumption patterns. However, in the current budget climate, it is unrealistic to expect Congress to adopt this "first-best" solution. Moreover, it is questionable whether direct subsidies allotted through the political process would be as efficient as is often thought. In theory, subsidies should be allocated to those firms offering the highest prospective returns. In practice, the political process tends to allocate subsidies on bases other than pure economic criteria.

Of course, the design of a non-subsidy protection program presents its own set of difficulties. One challenge is to ensure that any protectio granted is cost-effective. This goal can be realized only if the form of protection promotes rather than delays adjustment; otherwise, society will be forced to suffer the pain of higher prices without reaping the benefits that protection is designed to achieve.

A second challenge is to avoid making protection either too easy or too difficult to obtain. If it is too readily granted, protection will be awarded in many instances in which it is not appropriate, producing unnecessary costs for consumers. On the other hand, if escape clause relief is rarely forthcoming, domestic industries and their workers will seek other, perhaps more lasting and invidious forms of protection directly from the Congress. For example, President Reagan's decision in September, 1985, to reject the ITC's recommendation that the U.S. shoe industry receive temporary import protection is widely credited with intensifying protectionist sentiment in Congress. The result could be legislated protection, for years to come, of the U.S. shoe industry and other domestic industries; this would be far more costly to consumers than the declining quotas for footwear imports recommended by the ITC.

Many members of Congress are dissatisfied with the current U.S. escape clause law, and a variety of proposals have been made to change it. Unfortunately, some of these could actually reduce the capability of the escape clause mechanism to meet the two challenges just discussed.

One class of proposals, for example, would weaken the current legal causation standards, by which the ITC determines whether an industry's poor economic health has been caused by import competition. These proposals are difficult to justify in light of experience under Section 201. Since the standards were last eased in the 1974 Trade Act, the ITC has found import-induced injury in 32 of the 55 cases in which petitions for escape clause relief have been filed -- a "success" rate for domestic industries of almost 60 percent. Since some undeserving cases are now presented to the ITC, this proportion suggests that further relaxation of the causation test could yield an excessive degree of protection.

Another class of suggestions would make import relief conditional on commitments by domestic industries to modernize and reinvest. The model for this conditionality approach is the 1980 loan guarantee package for Chrysler, which Congress approved only after management and labor at the company agreed to a number of conditions on the firm's operations, including limits on employee compensation. Last year, Congress extended the conditionality concept to the steel industry, which benefits from export restraint arrangements with other steel-exporting countries. In the 1984 Trade Act, Congress conditioned the continuation of these arrangements on an annual presidential certification that major U.S. steel companies are reinvesting all their net cash flow in the steel business.

However, the Chrysler analogy is inapposite to the trade context. It is one thing for a creditor, such as the U.S. government, to impose conditions on a single debtor as a price for receiving credit or other financial assistance. It is quite another thing for government, not acting as a creditor, to negotiate conditions for an entire industry. That process inevitably facilitates coordination by domestic competitors of investment plans, product strategies, and even pricing decisions. The result can be cartel-like behavior that is totally at odds with U.S. antitrust laws and inconsistent with the interests of American consumers.

Equally significant, the conditionality approach violates our criterion that trade relief not be permitted to replace market forces. Conditionality unjustifiably presumes that government officials possess knowledge or information superior to that of the private sector. However, as in the 1984 Trade Act's reinvestment requirements for the steel industry, the bias of government will always be toward the expansion and modernization of a trade-injured domestic industry. Economic reality often confutes that bias; trade difficulties generally signify a need for exit from an industry, not for additional investment in it. Indeed, our analysis of a sample of 16 industries that received some type of import protection over the last two decades indicates that only one of them, the bicycle industry, increased its production and employment levels after protection was removed. The rest shrunk in size, although some were more successful than others in developing and introducing new products and technologies. Had the government required each of these industries to meet the kind of reinvestment conditions imposed on the steel industry in 1984, much investment would have been wasted.

A final class of proposed reforms stems from congressional criticism of how much discretion the current escape clause law allows the president once the ITC determines that import competition has seriously injured a domestic industry. Since 1975, the president has granted import relief in only 13 of the 32 cases in which the ITC has made an affirmative escape clause finding (although in five other instances, he has recommended expedited consideration of adjustment assistance for displaced workers). Given this record, some lawmakers have suggested the elimination of presidential discretion to accept or reject the ITC's import relief recommendtions. Others have urged that the decision to impose import barriers be vested in the United States trade representative (USTR), subject to a presidential override. This proposal seems to assume that the USTR would be more likely than the president to grant import relief once the ITC made an affirmative injury finding.

We favor some narrowing of presidential discretion under the escape clause procedure, but we do not support the proposals lawmakers have so far considered. Granting automatic import protection to industries found to be suffering from import-induced injury would run a dangerous risk of imposing too much protection. This would not only harm consumers, but damage relations with foreign trading partners. On the other hand, a transfer of import relief authority to the USTR would be unlikely to accomplish the objectives of its proponents, since the head of that office serves at the pleasure of and reports to the president.

Our Alternative Proposals - We recommend that the current law be changed in two respects. First, if the president decides to grant any import protection at all under the escape clause, he or she would be limited to imposing a four-year schedule of declining tariffs. In addition, all existing quotas (such as those on textiles, steel, beef, and sugar) would be replaced with tariffs set in advance to decline, but perhaps over periods longer than the five years provided for in the current escape clause. The first-year tariff levels would be established through auctions of quota rights.

Second, although the current legal standards for proving import-induced injury should remain intact, two components of relief should be triggered automatically upon an affirmative finding by the ITC. Workers in an affected industry who are laid off in the four years following the filing of a successful petition would become eligible for adjustment assistance (as described below). Revenues from any tariff imposed under the escape clause law would be earmarked to fund the assistance, with supplements from general appropriations as required. In addition, firms in an affected industry would be judged by proposed mergers involving antitrust standards that gauge competitive impacts in terms of the international market, rather than just the domestic one, provided that the industry is not benefiting from import protection. A change of this sort, which the administration has also been considering, would make approval of such mergers more likely.

This plan has a number of advantages. Its first feature eliminates the least cost-effective means of providing temporary industry assistance: quotas or OMAs. Unlike tariffs, the cost of which are transparent to consumers and lawmakers, quotas pose hidden costs. Perhaps more important, they make it easier for domestic producers with market power to increase their prices. Tariffs penalize imports, but also allow them to enter freely and act as a competitive check on outsized price hikes. Moreover, tariffs yield additional revenue for the government; quotas do not.

The second aspect of the plan -- the automatic relief components -- should provide sufficient ammunition to lawmakers to fend off demands for legislated protection. In contrast with current law, which vests certificaton authority in the ITC for import relief and in the Labor Department for adjustment assistance, the proposed plan would make both kinds of relief contingent on a single proceeding. Workers adversely affected by trade would not have to wait for adjustment assistance, which in the past has often become available only after displaced workers have already found new employment.

Finally, the proposed revision of antitrust standards for mergers involving companies in impacted industries would be, compared to the present system, a more socially productive strategy for inducing such firms to seek Section 201 relief instead of legislated alternatives. Under current antitrust law, merger standards are relaxed only for specific failing companies, not for all firms in a particular industry, and, in fact, the criteria for qualifying as a failing company are rarely met. In addition, until recently government assessments of the competitive impact of proposed mergers have rarely taken foreign producers into account. Our proposal would force antitrust officials to recognize that firms meriting relief under the escape clause are competing in world markets in which, in all probability, fewer firms with less capacity can survive. We reject, however, the Commerce Department's proposal to exempt such firms from merger standards altogether. This could produce highly concentrated markets, to the detriment of consumers.

Our plan does raise one complication in light of the current GATT rules for escape clause actions, which require the United States and other signatories to compensate trading partners when erecting tariff barriers. We believe that this requirement should be suspended when protection results from a transparent legal process and takes the form of self-liquidating tariffs. An exception in these circumstances would be far more in keeping with the spirit of the

GATT than the current compensation provisions, which, unfortunately, countries have avoided by resorting to discriminatory quota and voluntary export restraints that threaten to undermine market-based trade.

Assisting Adjustment by Workers

The Current Assistance Program - In principle, there is no reason why workers displaced as a result of import competition should be treated better than those dislocated because of other developments, such as technological improvements or shifts in demand patterns. Nevertheless, when it was first introduced in 1962, trade adjustment assistance for workers was justified as a means of compensating those adversely affected by tariff reductions. Currently, such assistance can be viewed as compensation for the more general dislocation costs of open trade. Presidents Ford and Carter, when subject to politically pressing demands for protection during election years, made effective use of trade adjustment assistance for affected workers. As shown in Figure 2, however, the Reagan administration has severely curtailed the most important component of trade adjustment assistance, Trade Readjustment Allowances (TRAs), despite unprecedented trade pressures.

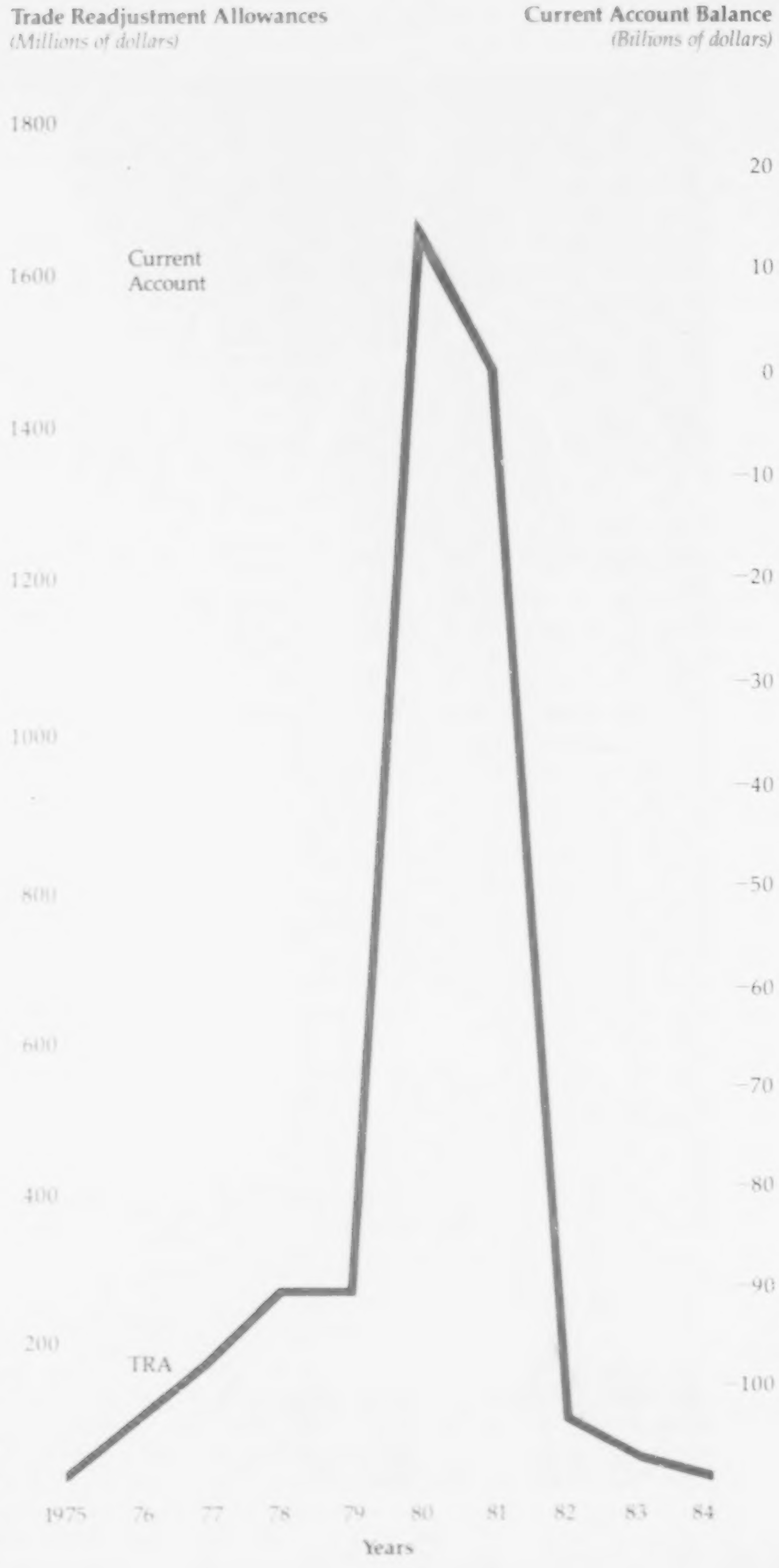
Unfortunately, defects in the design of the trade adjustment assistance program in recent years have obscured its potential usefulness as an anti-protectionist device. First, the manner in which TRA assistance has been provided has tended to discourage, rather than facilitate, worker adjustment. Congress recognized this problem in 1981 when it abandoned the previous TRA compensation system, which provided assistance to workers only during weeks in which they also collected unemployment insurance. Congress believed that this system encouraged displaced workers to stay home, rather than to seek new employment.

The new TRA compensation system, urged upon Congress by the Reagan administration and adopted in 1981, attempts to correct the incentive problem. Under the new system, trade-displaced workers not enrolled in retraining programs are eligible to collect TRA only after they have exhausted their unemployment compensation benefits. The period during which they get either type of aid may not exceed 52 weeks. For example, a worker who has received 39 weeks of unemployment compensation can then be eligible for no more than 13 weeks of TRA. (There is an exception to this rule: A worker can qualify for an additional 26 weeks of TRA payments by enrolling in a retraining program.)

The Reagan-era TRA program appears to have encouraged trade-displaced workers to pursue retraining, but not necessarily to search for and obtain new jobs. As shown in Table 1, the fraction of all workers receiving TRA benefits who entered retraining programs has increased sharply during the Reagan administration -- from 3.8 percent in fiscal years 1976-81 to 31.3 percent in fiscal years 1982-84. However, while the proportion of workers who have finished retraining programs has also risen, the percentage actually obtaining jobs for which their retraining qualified them has fallen -- from 7.6 to just 4.1 percent. These figures suggest that the TRA compensation system adopted in 1981 may have encouraged some workers to undertake retraining programs merely to continue collecting TRA benefits rather than searching for meaningful employment.

More generally, Table 1 indicates that, despite the incentives adopted by Congress in 1981, the preponderance of trade-displaced workers -- 68 percent

Figure 2.
Trade Readjustment Allowances (TRAs) and Current Account Balance



Note: TRAs based on fiscal years; trade balance on calendar years.

Sources: Employment and Training Administration, Dept. of Labor, unpublished data; Economic Report of the President, Council of Economic Advisers, February 1985; Economic Indicators, Council of Economic Advisers, August 1985.

-- have not sought retraining. These workers are simply not being encouraged to find work by the 1981 TRA compensation system, which tacks TRA payments onto the end of the unemployment compensation period.

The second problem with previous trade adjustment assistance programs is that the levels of compensation they have provided have borne a highly imperfect relationship to the economic losses that trade-displaced workers have actually sustained. In principle, those losses are equal to the total earnings missed due to unemployment plus the decline in earnings capacity in subsequent employment. For example, a steelworker who because of import competition is let go and must eventually accept a job as an auto mechanic loses not only income during unemployment, but also the value of his or her unutilized steelmaking skills (including both forfeited "human capital" and accumulated seniority).

Current and previous TRA compensation formulas have taken account of only the first of these components of earnings loss. The pre-1981 compensation system, for example, provided TRA and unemployment compensation benefits totaling 70 percent of a worker's former gross weekly wage (but not more than the national average of weekly manufacturing wages), minus amounts received for retraining and 50 percent of part-time earnings. Since 1981, displaced workers have been entitled only to extended TRA benefits equal to previous unemployment

Table 1: Trade Adjustment Assistance Data, Fiscal Years 1977-84

	FY 1977-81	FY 1982-84
(1) Total number of workers receiving TRA benefits	1,211,206	76,316
(2) Total number of workers who entered retraining	46,504	23,876
(3) Worker retraining ratio (2)/(1)	3.84%	31.29%
(4) Total number of workers who completed retraining	16,926	11,055
(5) Retraining completion ratio (4)/(2)	36.4%	46.3%
(6) Total number of placements after retraining*	3,509	968
(7) Placement retraining ratio (7)/(2)	7.55%	4.05%

*Placements, as a result of retraining, based upon specific job definitions used by state employment service agencies.

Source: Employment and Training Administration, Office of Trade Adjustment Assistance, Department of Labor.

compensation amounts, which are based roughly on a worker's prior earnings. Neither compensation formula has reflected declines in the earnings capacities of workers in subsequent employment. Two individuals who are unemployed for the same length of time may ultimately find new jobs paying vastly different wages, but under the present system both would receive the same amount of TRA.

Current Reform Efforts - At this writing, Congress is considering a reform bill, authored by Senator William V. Roth, Jr., that would only partially cure these defects. The Roth proposal would extend the maximum benefits period from 52 weeks to 78 weeks. It would require workers receiving benefits to be enrolled in, or to have completed, a training program funded by a $4,000 job retraining voucher. Vouchers would be redeemable for training in a variety of programs, including those under the Job Training Partnership Act, those approved by the secretary of labor, and those conducted without federal support by private firms. The Roth plan would be financed by an across-the-board import fee of up to 1 percent; the precise level would be set by the president. Congressman Donald J. Pease has introduced a House bill similar to the Roth proposal.

Although the Roth-Pease approach makes a constructive effort to increase worker skills, it has several important flaws. First, it would force workers to enroll in retraining simply to obtain extended unemployment compensation, rather than because the retraining would be cost-effective. Training may be useful for some workers, but a waste of time for others. Indeed, the track record of the Reagan administration's TRA program, in which only 4.1 percent of workers were placed in jobs for which they were trained, points to the limitation of this approach. In our view, subsidized training should be an option available to displaced workers, but it should be neither mandatory nor free.

A second flaw in the Roth-Pease proposal is that by extending unemployment benefits but not compensating workers who find alternative employment, it would continue the subsidization of those who fail to seek new jobs. Finally, although the basic rationale for adjustment assistance is to compensate those hurt when trade is kept free, the Roth-Pease program would also perpetuate the error of granting benefits to workers even if the industry from which they are displaced is protected by quotas -- the worst form of protection.

Our Alternative Proposal - In our judgment, a superior adjustment program would make compensation, training, and relocation benefits available automatically to workers displaced from industries that the ITC determines to be suffering serious injury from imports. The program could also be used to aid workers displaced from industries currently protected by quotas, such as textiles and steel, provided that the quotas are replaced with self-liquidating tariffs.

The compensation component of our proposal would provide qualified displaced workers with two types of earnings-related payments: unemployment compensation and earnings insurance. Existing unemployment compensation programs, which currently compensate eligible unemployed workers for up to 26 weeks in virtually all states, would be left undisturbed. In addition, trade-displaced workers residing in regions of high unemployment, where alternative jobs may be less plentiful, would be eligible for an additional 26 weeks of unemployment compensation payments. Any qualified worker who chose to move in order to obtain new employment would be eligible for a relocation allowance.

Earnings insurance payments, in contrast, would be made to trade-displaced workers only upon their accepting new employment; payments would equal a fixed percentage of any erosion in earnings for a particular period of time. Thus, if the compensation ratio were 50 percent, a displaced worker from a designated industry who had earned $20,000 a year in wages (as reflected on the worker's previous tax returns) and had accepted a new job with a salary of $10,000 would receive, for a specified period, supplementary payments calculated from a base of $5,000 per year. The proportion of income replaced could decline over time and could reflect the age and experience of workers. (For example, more junior workers who have built up less human capital in their specific job skills might receive lower replacement rates.) Also, the total compensation payments made to any worker over a given period could be subject to a legislated ceiling.

This proposed earnings insurance mechanism, in conjunction with unemployment insurance, would represent a significant improvement upon current and proposed trade adjustment assistance programs. By providing extra compensation to workers after they find new employment, the proposal would give them an incentive to adjust. Rather than remain idle in the hope of reemployment with their old firms, workers could accept jobs paying lower wages (but offering new career opportunities, training programs, and chances to build up seniority).

A second component of our proposed program would aid workers who prefer to enroll in state-certified training programs. Training expenses would be financed by a combination of grants and loans. Repayment of loans would be made directly through worker's tax returns and would begin only after workers have surpassed their previous peak wage earnings, as reflected on earlier tax returns. The proportion of the retraining cost repaid would vary with the incremental earnings of workers. Workers who exceeded their previous earnings by a large percentage would be expected to repay a larger percentage of their training costs. Such contingent repayment loans -- already in effect at some colleges -- would allow the government to take equity positions in its citizens. Indeed, contingent repayment should be made a feature of other educational and training loan programs.

Advantages of Our Industry and Worker Assistance Proposals: The Auto Industry as Case Study

The advantages of providing trade protection only in the form of tariffs and using the resulting revenues for trade adjustment assistance in the manner just outlined can be illustrated by examining what would have occurred if, from 1980 to 1984, such a program had been in effect instead of the Voluntary Restraint Agreement (VRA) regarding the export to the United States of Japanese automobiles.

According to the Department of Labor, between 1979 and January, 1984, 225,000 workers were displaced from the U.S. automobile industry. By January, 1984, two-thirds of these workers were reemployed, at median annual earnings some $4,000 per worker less than before. A tariff providing protection equivalent to that of the VRA would have easily funded a program to compensate for these earnings losses. According to Robert Crandall, whose analysis appeared in the Review earlier this year, the VRA increased the average price of Japanese cars by $1,000 in 1983. The tariff equivalent of this $1,000 per car increase would have yielded $1.85 billion in revenues. Such a sum not only would have funded full compensation for the annual income erosion of all reemployed auto workers (total cost $603 million), but also would have generated $16,000 for each remaining unemployed worker.

These calculations suggest that even a smaller auto tariff -- one that would have provided some relief for American consumers -- would have been more than sufficient to fund our recommended assistance program. According to Crandall, the VRA raised U.S. automobile employment by 46,200. Assuming that a tariff set at half the equivalent level of the VRA would have yielded only a corresponding half increase in reemployment, 23,100 workers would have been displaced. However, with such a lower tariff, U.S. consumers would have saved at least $500 dollars per Japanese car purchased (and approximately $200 dollars for each American car purchased). The revenue raised ($925 million) would have sufficed to offset two-thirds of the income lost by displaced workers reemployed at lower wages (a total cost of $445 million) -- and still yield $5,860 per unemployed worker for extended unemployment compensation, retraining, and other dislocation assistance.

The experience of the automobile industry over the past four years illustrates well the advantages of our proposal over trade quotas -- particularly because that experience poses a severe test. For one thing, a large number of workers who were indirectly aided by the VRA would not have qualified for our program because they were not actually displaced by imports. For another, given their above-average wages, autoworkers as a group experience relatively large earnings losses. In more typical cases, in which more of the employment displacement would be due to imports and workers would suffer less erosion of earnings than autoworkers did, the benefits of our plan could be even greater and the cost even lower.

Assisting Communities

A third major source of political pressure for protection is concern about the impacts of major plant closures on particular communities. Given the large fixed overhead costs of public facilities -- schools, utilities, police and fire services -- communities in which such closures occur are often forced to add the insult of additional taxes to the injury of an already shrinking populace. Although the concern about these effects has influenced the design of the trade adjustment assistance program, aid to impacted communities has been a virtually nonexistent part of the effort. In its absence, the only mechanism for helping these communities has been legislation adopted in a number of states requiring companies to provide notice in advance of plant closings.

We suggest that a new, positive approach be tried for assisting communities adversely affected by structural changes in the economy. Our proposal would not rely on general appropriations, because that route has proven to be a poor way to target regional assistance. In contrast to the relative success of the ITC procedures, which tie assistance to showings of trade-induced dislocations and confine aid to qualified industries, programs for aiding distressed regions -- such as the Model Cities initiative and the work of the Economic Development Administration -- have tended to expand beyond their orginal purposes.

Under our approach, communities would voluntarily choose to insure their tax bases against sudden erosion, rather than to depend on a government grant program. The tax base insurance program might, for example, allow a city experiencing an annual loss of more than 5 percent of its tax revenues for reasons other than rate reductions to recover from a government-administered insurance pool some proportion of that loss. The percentage threshold for tax base loss would vary by community size; a lower percentage loss would be required for larger cities. The pool would be financed through insurance premiums paid by communities that elect to join the program. Because the insurance coverage would extend to all sudden diminutions in a community's tax base, all types of communities, not just those experiencing steady long-term population erosions, would be encouraged to participate.

It is possible, of course, to confine such a program to trade-related tax base losses. A mechanism similar to the Section 201 procedure now in effect for industries harmed by trade could be established to determine the causal role of trade in regional economic injury. However, given the voluntary and potentially self-financing nature of our tax base insurance plan, there is no reason in principle or practice why the program should be so restricted.

Conclusion

It is ironic that, despite its commitment to free trade ideals, the Reagan administration has resorted to more extensive quota protection than its recent predecessors. The irony is compounded by the administration's own macroeconomic policies, which stimulate pleas for protection, and by administration cutbacks of adjustment assistance programs that, if effectively designed, could allow a non-protectionist response. Given the current, dangerously protectionist environment, the programs outlined in this article could be an effective microeconomic adjustment strategy complementing the fiscal policy corrections that are required to place the U.S. economy on a path of sustainable growth without permanent protection.

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Tokyo To Extend Car Export Restraints For Sixth Year

Tokyo has deployed its single most powerful tactical weapon in the running battle to derail congressional momentum for protectionist legislation targeted at products stamped "Made in Japan." On February 13 International Trade and Industry Minister Michio Watanabe announced that shipments of Japanese-made cars to the United States will remain capped at 2.3 million units through March 1987. The decision to limit exports for a sixth year was strictly political, dictated by the fallout in Washington from the huge and expanding U.S. trade deficit with Japan. Whatever economic rationale underpinned the 1981 bilateral agreement to shelter American automotive manufacturers from the full brunt of Japanese competition for three years has been swept away by the U.S. Big Three's record or near-record profits in the 1983-85 period.

Japan's decision to continue export restraints for yet another twelve months came as no surprise, but the timing of the announcement caught most analysts off-guard. As recently as late January, MITI sources were saying that Tokyo's position on the extension issue would not be finalized before early March. In moving up this schedule at the last minute, the Japanese government apparently concluded that it had more to gain than lose from going public with a decision described as "unavoidable" by MITI Minister Watanabe. Above all, policymakers in Japan wanted to prevent a replay of the trans-Pacific wrangling that inflamed bilateral relations in the months leading up to its March 28, 1985 announcement that shipments would be restricted through this March. Tokyo also clearly hoped to take some of the sting out of the news that the red ink in this country's trade account with Japan had swelled from $36.8 billion in 1984 to $49.7 billion last year and that it showed few signs of receding in 1986.

The White House's reaction was a classic example of "once burned, twice shy". Last year the Japanese government embarrassed the administration by opting to extend the restraints after President Reagan had decided not to ask for a continuation (see JEI Report No. 13B, April 5, 1985). This time around the White House not only greeted the Japanese announcement with "studied silence," to use one U.S. editorial writer's phrase, but also went to some lengths to distance itself from the Japanese decision. U.S. Trade Representative Clayton Yeutter stated that Washington did not ask the Japanese to maintain a lid on U.S.-bound car shipments. "It was their decision alone," he emphasized, adding that export restraints are not a substitute for efforts to improve market opportunities in Japan for American exporters.

Elsewhere, news of the quota extension generated a predictable response. Members of Congress generally applauded the decision but warned that it would not get Tokyo off the hook (see following article). Spokesmen for Ford Motor Co., Chrysler Corp. and the United Auto Workers union used adjectives like "constructive" and "appropriate" to describe the announcement, although they too called for action by Japan to rectify the bilateral trade imbalance. General Motors Corp., however, broke ranks with its two smaller rivals, expressing disappointment at an outcome that will again limit the number of cars it can import for sale under the Chevrolet nameplate.

Most columnists and editorial writers depicted Tokyo's decision as smart politics but bad economics. Car buyers, they reminded readers, will be stuck with artificially inflated sticker prices on both Japanese-assembled cars and domestic makes for at least another year, while American manufacturers will have to deal with stepped-up competition in the most profitable segments of the U.S. market. Industry analysts took a different tack, arguing that the continuation of export restraints will have little effect on sales of Japanese cars during the April 1986-March 1987 period, even though auto makers had estimated that their U.S.-bound shipments might jump by as much as 20 percent if controls were lifted. In this view, weaker domestic car demand coupled with the sharp run-up in the yen's value, Detroit's willingness to use cut-rate financing and other incentives to move cars and the arrival of new foreign competitors in the market's low end, lessen the chances that Japanese manufacturers will sell enough cars to bump up against the 2.3 million unit export ceiling (see JEI Report No. 3B, January 24, 1986).

The reaction in Japan's automotive industry to a sixth year of restraints was muted. Representatives of the top makers accepted the quota extension as politically inevitable, although there was widespread disappointment that the shipment cap was not raised. This option, however, was apparently never considered by the Japanese government once it concluded that the export restrictions had to be maintained -- and for good reason. The backlash triggered by last year's decision to hike the ceiling from 1.85 million units in the twelve months through March 1985 to 2.3 million cars in the current restraint period eliminated whatever political goodwill had been generated in Washington by the announcement that competition from Japanese exporters would again be throttled.

Saddled with their present export allocations for another year (see accompanying table), corporate planners at Japan's automotive companies are busy reviewing their U.S. marketing strategies. Honda Motor Co., Ltd. officials have the easiest job. Starting this summer, the number-three importer will have the capacity to turn out twice as many cars each year as the 144,000-plus vehicles it assembled at its Marysville, Ohio plant in 1985.

Unofficial Quota Allocations, FY 1981-FY 1986

(in units)

Exporter	FY 1981-FY 1983 Quota	FY 1984 Quota	FY 1985-FY 1986 Quota
Toyota Motor Corp.	516,659	551,792	620,800
Nissan Motor Co., Ltd.	456,030	487,040	547,900
Honda Motor Co., Ltd.	348,631	372,338	428,600
Mazda Motor Corp.	159,282	173,468	229,700
Mitsubishi Motors Corp. (including sales to Chrysler Corp.)	112,584	122,612	186,200
Fuji Heavy Industries, Ltd.	70,014	76,250	117,200
Isuzu Motors, Ltd. (including sales to General Motors Corp.)	16,800	49,500	117,100
Suzuki Motor Co., Ltd. (for sale to General Motors Corp.)	0	17,000	52,500
Total*	1,680,000	1,850,000	2,300,000

*Not included in these figures are the separate quotas on exports of four-wheel-drive vehicles, station wagons and mini vans and on shipments to Puerto Rico. These quotas are estimated at 112,900 units and 95,700 units, respectively, for FY 1985 and FY 1986.

Marketing people at Nissan Motor Co., Ltd., the maker of the second-largest-selling import, also have some built-in maneuvering room since the company's facility in Smyrna, Tennessee is gearing up to produce 120,000 to 140,000 cars annually by the end of 1986.

Import leader Toyota Motor Corp. could be in the biggest bind since its recently announced assembly plant in Georgetown, Kentucky will not come on-stream until late 1988. In the interim, Toyota's only source of additional cars will be its joint manufacturing venture with GM, which is scheduled to start making 30,000 to 50,000 vehicles a year for Toyota dealers this August. Other Japanese makers are in an equally tight spot. Although Mazda Motor Corp. and Mitsubishi Motors Corp. are building U.S. assembly facilities, their plants will not go into operation until the fall of 1987 and late 1988, respectively. For them as well as Fuji Heavy Industries, Ltd. (the manufacturer of Subaru vehicles), Isuzu Motors, Ltd. and Suzuki Motor Co., Ltd., exports will be the only source of supply for the coming quota year.

Susan MacKnight

Capitol Hill Reacts Favorably To Extension Of Car Restraints, But Warnings About Retaliation Continue

Although the announcement that Japan would maintain its restraints on auto exports through March 1987 was generally greeted with enthusiasm by members of Congress, most refused to discount the possible enactment of protectionist legislation this year. Sen. John Danforth (R, Mo.), head of the Senate Finance subcommittee on international trade and architect of numerous Japan-specific measures designed to retaliate against perceived unfair trading practices, said he was pleased with the news and hoped that Japan recognized that in order to export it must import more goods from abroad. He did not, however, indicate that his bills targeting Japan would be affected by this development.

Despite the positive reaction, few on Capitol Hill thought the decision would do little more than temporarily appease congressional anger at the record $49.7 billion U.S. trade deficit with Japan. Even those who applauded Tokyo's move noted that the deficit has soared despite five years of export restraints. Moreover, given the number of complaints against Japan, the resolution of one issue hardly relieves Congressional pressure to act on telecommunications equipment, semiconductors, wood products, machine tools, or any one of a number of other hotly contested trade items, separately or en masse.

There is also a muted backlash discernible in Washington. Some hard-line advocates of protectionism construe Japan's move as blatently manipulative, aimed as it is at undercutting attempts to enact retaliatory legislation. "All I get from this is that the Japanese have learned to play the U.S. trading relationship like a violin," Sen. Donald Riegle Jr. (D, Mich.) told a New York Times reporter.

Interest in what Japan does about U.S.-bound car exports is not just limited to the extreme ends of the trade debate. Legislators in the more moderate spectrum view autos as a political flashpoint as well. They are in

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JEI

REPORT

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CAPITAL MARKET LIBERALIZATION IN JAPAN

Summary

Japan's financial system has made an important contribution to that country's high level of investment and rapid economic growth. Between 1952 and 1973 business investment in Japan increased by an average annual real rate of 14.4 percent. One of the key factors in this expansion was the system's ability to channel household savings into productive domestic investment at a low cost to borrowers.

The economic events of the 1970s led to substantial capital market liberalization in Japan, and the pace accelerated after the November 1983 U.S.-Japan agreement on financial reform. During the past two years, Tokyo has liberalized its foreign exchange market and introduced three new yen instruments to be traded -- Euroyen bonds, bankers' acceptances and bond futures. The major changes in Japan's financial system have helped make Tokyo an important international financial center and, it is hoped, will lead to increased international use of the yen. They have also been instrumental in turning Japan, with its high saving rate, into the largest creditor nation in the world.

The Evolution of Japan's Financial System

Despite Japan's emergence as a major economic power, its financial system remained tightly regulated and isolated from the rest of the world until the first oil crisis in 1973. A high degree of specialization among financial institutions limited access to markets. As in the United States, banks were excluded from the securities market and prohibited from underwriting or dealing in securities. The commercial banking business was further separated into city (nationwide) and regional banks, long-term credit banks and trust banks. The management of trust funds was restricted to the eight trust banks and 21 domestic insurance companies. City and regional banks, which specialized in short-term lending, raised funds from deposits and by borrowing from both the interbank market and the Bank of Japan. Long-term credit banks did not accept deposits but were allowed to issue debentures to raise funds.

The system concentrated an enormous amount of economic power in the nation's central bank -- the Bank of Japan -- and the Ministry of Finance. The BOJ set interest rate ceilings for all major types of deposits, and the prime rate and other important lending rates were tied to its official discount rate. Since interest rates were set below market-clearing levels, there was usually excess demand for bank credit. Furthermore, setting the discount rate below equilibrium levels gave the central bank power to ration credit. The framework of specialization among financial institutions helped enforce interest rate controls by limiting substitution among assets and preventing arbitrage among markets.

Capital controls on international transactions and foreign exchange helped to preserve Japan's financial structure by insulating it from foreign influences. Under the Foreign Exchange Control Law of 1949, all foreign exchange and capital transactions were subject to government control unless specifically exempted. The purpose of the law was to prevent Japanese companies from circumventing credit restraints by borrowing abroad and to prohibit the foreign takeover of domestic companies. It was also intended to help prevent balance of payments problems that would force a devaluation of the yen.

Additionally, restrictions on the issuance of yen-denominated bonds by foreign firms in Japan slowed the development of the domestic securities market. Short-term capital inflows through banks were subject to yen conversion limits, while foreign banks were not permitted to borrow funds from the call money market. These types of restrictions made the overseas role of Japanese financial institutions and the activities of foreign institutions in Japan relatively minor.

Although the numerous regulations introduced inefficiencies into financial markets, the system was well-suited to Japan's need for cheap capital to increase productive capacity in the years following the war. Much of the burden was borne by the household sector, which earned a lower return on its savings than would have been the case in a less regulated environment. But this loss was largely offset by the benefits that accrued from the 10 percent-plus annual real growth of national income during the 1960s.

Financial Liberalization in the 1970s

Economic events in the 1970s led to forces for change in the rigid financial structure. The two major oil price increases and the breakdown of the fixed exchange rate system resulted in higher rates of inflation, slower

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economic growth and volatile changes in the value of the yen. With fixed nominal interest rates, inflation produced abrupt changes in real returns. Although for most of the decade inflation was lower in Japan than in most other advanced countries, it did make savers aware of the hazards of low-yielding deposits and led to pressure for reform.

Slower growth in the years after the first oil shock led to a decline in private investment's share of the gross national product from 33.9 percent in 1970 to 26 percent in 1975. As corporations frequently had excess funds in the slower-growth environment, they, too, became more sensitive to the rate of return on financial investments. With reduced net borrowing by the corporate sector, the government began to play a larger role in supporting domestic demand and absorbing the high level of household saving. Consequently, although policymakers had previously adhered closely to balanced budgets, the government began to issue large amounts of bonds. The increase in government debt, which rose from 6 percent of GNP in FY 1972 to 29.3 percent in FY 1980 (see Table 1), had a major impact on Japan's financial system.

The impact of the major changes that occurred during the 1970s on banking, money markets and international capital flows is discussed below.

The Banking Sector - The Ministry of Finance initially sold government bonds with a maturity of 10 years at below-market interest rates to a syndicate made up of major commercial banks and securities dealers. The syndicate was allowed to resell newly issued bonds after a waiting period of one year. As the volume of government bond issues rose, however, banks became increasingly reluctant to accept them for several reasons. Given the increasing uncertainty over interest rates, the risk of capital losses on sales of bonds in the secondary market was great. In addition, the increasing share of government bonds in the banks' portfolios from 2.2 percent in 1975 to 7.8 percent in 1978 lowered profits. Furthermore, the expanded holdings of long-term government bonds did not match the banks' short-term deposit liabilities.

To make these issues more attractive, the government revised certain issuing and trading practices. In 1977 it instituted five-year discount bonds and the following year began issuing bonds with maturities of two to four years at public auctions, allowing investors to purchase these instruments directly at market terms. In 1981 the time period required for banks to hold new issues of bonds before selling them in the secondary market was reduced to 100 days. As a result of these changes, banks ceased to be net buyers of government bonds and their share of central government debt fell from 29.5 percent in 1979 to 16.2 percent in 1982.

The Revised Banking Law of 1981 allowed some banks to deal in government securities with the general public. Although it was intended to facilitate the issue of government bonds, the law represented a significant blurring of the traditional separation of commercial banking and the securities business. It promoted further expansion of the secondary bond market and strengthened the links between primary and secondary markets.

With the introduction of financial instruments with market-determined interest rates in the late 1970s, the funding of city banks, which depended entirely on fixed-rate deposits, deteriorated. To help them compete, banks were permitted in 1979 to issue their own free-market instrument, negotiable certificates of deposit. Furthermore, restrictions on participation in the gensaki market (which consists of the resale or repurchase of bonds at a fixed price after a fixed period) were removed in 1979 and secondary trading in CDs began in 1980. One consequences was greater interest rate arbitrage and the integration of interbank markets with unregulated markets outside the banking system.

Short-Term Money Markets - Liberalization of short-term money markets -- the call, bill discount, CD and gensaki markets -- was linked to the conduct of monetary policy. Then as now, the call and bill discount markets operated as interbank markets with six specialized dealers through which transactions had to be placed. The gensaki market was open to all financial institutions.

In the 1960s and early 1970s, the Bank of Japan's monetary policy focused on controlling the volume of bank credit through its loans to city banks and strict control over the interbank market. In addition to posting interest rates in the call market, the bank monitored the allocation of funds and intervened through the six middlemen. The bank also controlled credit through window guidance, which set quotas on the volume of loans by each bank during periods of monetary restraint.

With the emphasis on controlling inflation during the 1970s, the central bank shifted from relying extensively on quantitative limitations toward a more market-oriented policy that centered on controlling the money supply. In any case, the effectiveness of controls on bank loans had declined as the business sector's need for credit contracted following the first oil shock. Monetary policy began to focus on the cost of credit, necessitating greater flexibility in short-term interest rates. Posted rates in the call market were discontinued in 1979 and one-, two- and three-month bills with unregulated interest rates were introduced in the bill discount market. Although "official controls" over the call and bill discount markets were removed, the central bank still maintains close surveillance and intervenes in both markets.

International Capital Flows - Liberalization of the regulations governing international capital flows proceeded at an uneven pace in the 1970s, influenced by changes in the exchange rate. Tokyo responded to both increases and declines in the yen's value by generally reducing barriers in order to induce an offsetting capital flow. In other words, it tended to lower restrictions on capital inflows when the yen depreciated and on capital outflows when it appreciated.

To encourage capital inflows in the period immediately following the first oil crisis, for example, Tokyo liberalized the rules governing inward investments in various Japanese industries, facilitated the issuance of bonds abroad by residents, and raised the ceiling on loans from overseas. Simultaneously, the government took steps to curb the outflow of capital, temporarily halting foreign bond issues in Japan, limiting financial institutions' foreign exchange holdings and restricting overseas lending by Japanese banks.

When the yen appreciated during the 1977-78 period, Tokyo changed course. It eased restrictions on purchases of foreign bonds by Japanese, granted foreign exchange banks greater freedom to lend abroad, and eliminated the approval requirement for direct overseas investment. The fall in the yen's value after the second oil price hike, however, brought another policy shift, this one in the direction of facilitating an inflow of capital. To cite just one example, starting in 1979, nonresidents were permitted to participate in the CD and gensaki markets, a significant step that increased the integration of Japan's short-term financial markets with those abroad.

These changes led to a more open system, as a glance at the large increase in capital flows between Japan and the rest of the world (see Table 2) demonstrates. By 1980 the government was ready to acknowledge formally its basic policy switch on the movement of capital into and out of Japan. The Foreign Exchange and Foreign Trade Control Law of that year established the principle that all international financial transactions are free of controls unless otherwise specified. The new law widened the scope for foreign portfolio investment in Japan and gave domestic companies greater freedom to borrow abroad. The impact of this law is illustrated by the tripling of foreign purchases of Japanese securities between 1979 and 1981.

The link between changes in the exchange rate and liberalization efforts was broken in the 1980s. Despite a weakening yen during most of 1981 and 1982, Tokyo continued to open up its capital markets by relaxing limits on syndicated loans arranged by Japanese banks and easing the restrictions on bond issues in foreign markets by subsidiaries of Japanese banks.

These changes in Japan's financial system had a major impact on the pattern of corporate finance. During the 1960s and much of the 1970s, firms relied heavily on bank loans rather than on direct financing through the bond and equities markets. There were several reasons for this. First, investors did not view stocks and bonds as safe assets due to the undeveloped state of the Japanese securities market. A stable market in corporate bonds requires the existence of a developed market in risk-free government securities to act as a reference against which to evaluate corporate bonds. Such a market did not exist in Japan due to the small amount of government bonds outstanding prior to 1975 and the limits on their resale by syndicate members. Moreover, there were restrictions on foreign issues of securities by Japanese companies and on nonresident purchases of Japanese equities. The development of the government bond market and the deregulation of the securities market, however, have enabled corporations to broaden their use of direct financing.

The Yen-Dollar Accord

Throughout the 1970s, financial liberalization proceeded steadily but deliberately. While financial institutions pressed for greater deregulation, Tokyo carefully orchestrated the changes to avoid disrupting financial markets that were dependent on the structure of regulation and to maintain control of monetary policy. Few new financial instruments, with the notable exception of the gensaki market, were allowed to develop spontaneously.

In 1983 Japan came under increasing international pressure to accelerate the pace of liberalization of its financial markets. Part of this pressure was based on the ideological conviction that free financial markets are superior and that regulations reduce efficiency in allocating capital. Analogous to the case for free trade of goods, economists generally agree that both global and national welfare is best served by unrestricted capital flows.

U.S. pressure for reform was also based on the belief that Japanese financial regulations had driven down the value of the yen by making it an unattractive currency. More open capital markets, Washington believed, would increase international use of the yen, raising its value and reducing trade problems. Another important motive was increased access to Japanese capital markets for foreign financial firms, which complained that regulations hindered them from playing a larger role in financial transactions in which they were competitive. Greater access would also enable American institutions to tap Japan's large supply of savings. At the same time, though, these capital outflows would tend to weaken the yen.

The result was the November 10, 1983 agreement between then-Treasury Secretary Donald Regan and Minister of Finance Noboru Takeshita covering specific measures to liberalize Japan's financial markets. Beryl Sprinkel, at that time under secretary of the Treasury, hailed the pact as "an important milestone in [Tokyo's] philosophical approach to financial and capital markets" that "created the basis for fundamental change." A yen-dollar working group was established to monitor progress in implementing the measures and to pursue additional steps.

The measures taken by Tokyo as a result of the yen-dollar accord can be divided into four categories: the liberalization of Japanese barriers against the inflow and outflow of capital; the internationalization of the yen; more favorable treatment of foreign financial institutions in Japan; and deregulation of domestic Japanese capital markets. The changes Japan has initiated in each of these categories during the past two years are discussed below.

Liberalization of Barriers to Capital Flows - One of the most important measures was the relaxation of rules covering samurai bonds (yen-denominated bonds issued in Japan by nonresidents), which were first introduced in 1979. In June 1984 the Ministry of Finance lowered the credit rating required for issuers, reduced the waiting period between issues and raised the permitted size of each issue. These changes led to a sharp increase in the volume of samurai bonds issued in 1985 to slightly more than Y1.1 trillion ($5.6 billion at Y200=$1.00). In addition, there have been five issues of shogun bonds (dollar-denominated bonds issued in Japan by nonresidents) since that instrument was approved by Tokyo last April.

In the 1982-83 period, the Ministry of Finance set quantitative limits on overseas yen lending by Japanese banks out of concern over the low value of the yen and the international debt crisis. In 1984, however, restrictions on the overall amount of lending and the accompanying country limits were abolished, leading to a substantial rise in foreign yen loans.

Another significant reform was the end to the ban on the sale of foreign commercial paper and CDs in April 1984. This step, originally planned for 1982, had been delayed to avoid depressing the yen through large capital outflows. In addition, regulations on financial accounts held by residents abroad were eased, a move that will contribute to the efficient use of Japan's savings surplus.

In addition to the above measures, which liberalized capital outflows, the Diet in May 1984 abolished the "designated company" system governing foreign direct investment in Japan. Under this system, nonresidents were prohibited from acquiring more than a specified percentage of certain designated companies (11 in all). The same law liberalized real estate purchases for foreigners in Japan. Moreover, restrictions on short-term Euroyen loans to Japanese residents were lifted in June 1984, producing a steady increase in the volume of such lending.

In response to the U.S. proposal that Tokyo finance its government deficit overseas rather than in Japan, legislation authorizing overseas bond issues was passed in 1984; however, the new borrowing authority has yet to be used. Overseas borrowing by government-affiliated agencies, though, has contributed to efforts to raise the value of the yen. The Japan Development Bank, for example, issued $100 million of bonds in New York on two occasions in 1984 and another $200 billion in November 1985.

Internationalization of the Yen - As mentioned above, one of Washington's goals was to increase the value of the yen by promoting its use as a transaction currency in trade, an investment currency by nonresidents and a reserve currency by foreign governments. In the past Japanese monetary authorities, like those in other countries, were concerned that extensive foreign holdings of their currency would reduce the government's control over the money supply and increase the variability of the exchange rate. But capital flows do not affect a country's monetary base unless the central bank intervenes in the foreign exchange market. And, in fact, the yen has undergone wide swings in its exchange value despite the fact that it has been less widely used internationally than other major currencies.

Although the share of the yen in global official foreign exchange reserves doubled from 2 percent in 1976 to 5.2 percent in 1984, it is still small relative to the dollar's 65.1 percent share and the West German mark's 12 percent share. Given the size of Japan's economy, the percent of its trade denominated in yen in surprisingly small. Only 3 percent of Japan's imports are valued in yen, while about 40 percent of the foreign purchases made by Germany, the United Kingdom and France are denominated in local currencies. One reason for the low use of the yen is that a high percentage of Japan's imports are raw materials, most of which are priced in dollars worldwide. Moreover, the absence of a bankers' acceptance market in Japan until recently and the quantitative controls that formerly restricted bank lending encouraged importers to obtain trade credits abroad.

One step toward wider use of the yen was the removal of the "real demand rule" in April 1984 that limited foreign exchange transactions to those that covered specific real transactions. This change has led to a large increase in foreign currency operations since purely speculative transactions are now permitted. A market in bankers' acceptances, which are issued by exporters and importers in exchange for cash to underwrite trade transactions, opened in June 1985. This market should encourage banks to link short-term loan rates to the market, bringing free-market forces to short-term lending. But increased demand for yen, a major goal in the establishment of this market, may not be fulfilled since traders can reverse their yen position in the foreign exchange market. Washington hopes, though, that increased use of the yen as a unit of account will increase the demand for yen as an asset. The failure of the bankers' acceptances market to live up to expectations thus far is attributed in part by some observers to complex rules governing the market.

Japan's restrictions on the Euroyen market, an area of strong bilateral contention, have also been liberalized during the past two years. Domestic and foreign banks can now issue and trade short-term negotiable Euroyen CDs outside of Japan; however, issuance of this instrument has been lagging because the maximum allowed maturity of six months is too short. Since April 1984, moreover, the Finance Ministry has permitted some Japanese firms to issue yen-denominated bonds in the Euromarket, with about 90 firms eligible initially. Although securities firms had pushed for letting some 700 domestic firms issue Euroyen bonds, a further lowering of asset and balance sheet requirements in April 1985 increased the number of eligible firms to only 145. The Finance Ministry also requires that firms wait 180 days before repatriating funds raised in the Euroyen market. Since restrictions on domestic borrowers become irrelevant as curbs on using the Euroyen bond markets are lifted, Tokyo has been reluctant to make wholesale liberalizations for fear of disrupting the domestic bond market.

The United States also singled out Tokyo's initial 20 percent withholding tax on Euroyen bonds issued by Japanese firms as a serious disincentive to expansion of this market, since the tax made the bonds unattractive and blunted the effectiveness of the reforms. Given its fiscal situation, the Nakasone administration was not anxious to reduce government revenues, but on April 1, 1985 Japan followed the United States, Germany and France in eliminating the tax for nonresidents. This action contributed to the impressive total value of Y1.4 trillion ($7 billion) in Euroyen bonds during 1985, the first full year after liberalization. The 63 Euroyen bonds issued accounted for 5.2 percent by value of all Eurobond issues in 1985, compared to 1.5 percent in 1984.

Since December 1984 Tokyo has allowed non-Japanese corporations to issue yen bonds in the Euromarket. Prior to that time the issuance of such bonds was limited to foreign governments and international financial institutions. Tokyo imposes no restrictions on the size and number of Euroyen bond issues by nonresidents and allows any bank or securities firm to serve as lead manager. Foreign firms accounted for all but seven of the 63 Euroyen bonds issued last year, as Japanese companies found it cheaper to issue Eurodollar bonds. Innovations, such as zero-coupon, floating-rate and dual-currency bonds (allowed since June 1985), helped the volume of the Euroyen bonds to exceed the volume of samurai issues in 1985.

Treatment of Foreign Financial Institutions in Japan - Foreign banks have been authorized to trade in government bonds in the secondary market and to join the underwriting syndicate that purchases newly issued government bonds since April 1984. Swap limits -- restrictions on the amount of foreign currency that each foreign and Japanese bank could convert into yen for lending purposes -- were abolished two months later. Ironically, many foreign banks in Japan have been hurt by deregulation, which has denied them some of the special privileges they enjoyed in the past.

A major issue has been the entry of foreign banks into the business of managing trust and pension funds in Japan. This is likely to become an increasingly lucrative business, as corporate pension funds are expected to increase from $100 billion in 1984 to $300 billion in 1995 due to the rapid aging of Japan's population. The MOF has thus far approved the applications of seven foreign banks to participate in trust banking operations; two additional banks are expected to be approved.

On February 1, Merrill Lynch & Co. became the first foreign brokerage house to execute trades on the Tokyo Stock Exchange, the world's second-largest equity market. Of the 10-seat increase in the TSE's membership last December, six were assigned to foreign financial firms, including Morgan Stanley & Co. and Goldman Sachs & Co. as well as Merrill Lynch. The admission of foreign firms should facilitate the purchase of Japanese equities by nonresidents and increase the trading of foreign stocks in Japan.

Liberalization of Domestic Capital Markets - Negotiations in this area have focused on reducing interest rate controls to give free-market forces more of a role in determining the flow of financial resources. Controls on large time deposits of Y1 billion or more ($5 million) were removed in October 1985, and those on deposits of Y500 million ($2.5 million) will be lifted this spring. The MOF hopes to lift controls on deposits of Y100 million ($500,000) and above by the spring of 1987 -- a major landmark in the deregulation of financial markets that should lead to across-the-board relaxation of interest rate controls.

There has also been steady deregulation of the CD market. The ceiling on the amount banks can offer has been raised and the minimum denomination, which was lowered from Y500 million ($2.5 million) in 1983 to Y100 million ($500,000) in April 1985, is likely to be reduced to Y50 million ($250,000) next year. In June 1985, moreover, securities firms began trading these instruments for the first time. This move, which further lowers the barriers separating the banking and securities industries, should help expand the market beyond the current Y500 billion ($2.5 billion) level.

A new instrument, money market certificates, was introduced last March, with a rate of return pegged 0.75 percentage point below the CD rate, which is market-determined. In the spring of 1987, the minimum denomination is scheduled to drop to Y20 million ($100,000) and the maximum maturity of both CDs and MMCs is expected to be increased to one year. The deregulation of interest rates on deposits and the lowering of the minimum denomination on MMCs planned through the spring of 1987 are expected to reduce bank income as much as 37 percent.

A short-term (maturity of less than a year) bond market began last April. In June the government increased the number of banks allowed to deal in outstanding government bonds from 37 to 87. All maturities, except new issues, may be freely traded. A market in bond futures, which opened on October 19, 1985, got off to a rocky start. While it was designed to help dealers hedge their risks on new issues of government bonds, the rise in interest rates on October 25 led to a flood of selling and several securities firms lost millions of dollars.

Outlook

Japan's financial system has changed significantly since the early 1970s. Financial activities have been substantially decontrolled and new markets and instruments have been created. Liberalization of rules covering the activities of Japanese firms overseas and foreign firms in Japan has increased the internationalization of the system. The narrowing of the differential between the London Euroyen interest rate and the gensaki rate in Japan demonstrates that Japan is open to international flows of short-term capital.

The amount of new bond issues in FY 1984 was Y43.6 trillion ($218 billion), compared to Y7.3 trillion ($36.5 billion) in FY 1971. The public sector's share increased from 32 percent to 54 percent during that period. The outstanding balance in short-term money markets also increased from Y2.4 trillion ($12 billion) at the end of 1970 to Y25.8 trillion ($129 billion) at the end of 1984. The CD market has overtaken the bill discount market as the largest short-term money market.

While the development of the stock market has been uneven, the sales value increased from Y12 trillion ($60 billion) in 1970 to Y831 trillion ($4.2 trillion) in 1984. Foreign purchases of Japanese stocks, which have fluctuated sharply as well, rose from $1 billion in 1970 to $35.9 billion in 1984.

These changes should lead to increased use of the yen in trade and as an investment and reserve currency. The internationalization of the yen, though, cannot be achieved unilaterally since it depends on the decisions of traders, investors and foreign governments; therefore, it is likely to increase gradually.

Capital market liberalization has also made Tokyo an important financial center. In terms of gross bond issues, Japan is the second largest (excluding the Euromarket). It is the third-largest market for foreign bond issues, with a share that has risen from 0.3 percent in 1976 to over 13 percent in 1982. The market value of stocks listed on the Tokyo Stock Exchange is more than double the London Stock Exchange, although there are fewer foreign companies listed. Some observers believe, however, that Japan's high withholding tax and its tax on equity transactions will limit Tokyo's role as an international financial center.

The effect of these changes on the yen's value -- a major motive for U.S. pressure for liberalization in 1984 -- is less clear. Many of the reforms encourage the outflow of capital, which weakens the yen, but in general, capital market liberalization has not had a major impact on the yen's value. It is clear that, given Japan's low interest rates, measures that free international capital flows while interest rates are still controlled will encourage capital outflows. Complete liberalization, though, should raise Japanese interest rates to world levels and remove the incentive for outward flows.

The impact of liberalization on the volatility of changes in the yen's value is uncertain as well. Some expect it to increase volatility, as the absence of capital controls leads to larger flows. But capital controls have led to thin markets susceptible to sharp fluctuations, and their removal should result in a deeper, more stable market.

Despite substantial progress, financial markets in Japan are still less developed and more restricted than in the United States, and Tokyo remains under pressure to continue the liberalization process. Last December Assistant Treasury Secretary David Mulford criticized Tokyo for maintaining controls on which companies may issue Euroyen bonds. Washington wants Tokyo to replace its current system, which is based on various financial criteria, with the type of rating system used by other countries. Mr. Mulford also complained about the lack of an active and liquid secondary market for Euroyen bonds. This situation is largely a result of the common practice of channeling the bonds to Japan. The U.S. official also called for reduced restrictions on the trading of Japanese government bonds, including additional licenses for foreign banks.

A major issue is the continued decontrol of interest rates, including those on small deposits. Most interest rates paid on bank and postal savings deposits are fixed at low levels. This impairs efficiency in terms of the allocation of both capital and equity, as wealthy investors receive higher returns. Prior to the lifting of controls on small deposits, which is expected to begin in the spring of 1987, the Finance Ministry plans structural changes, such as improving deposit insurance, to increase the stability of the market for small savers. It will also have to tackle reform of the postal savings system, which holds more than Y10 trillion ($50 billion) in deposits and absorbs 32 percent of all personal savings in Japan. Banks complain that they cannot compete since postal savings rates are set higher than bank deposit rates and the system is free from taxes, deposit insurance and reserve requirements.

The separation of banking and the securities business is likely to continue to erode in the future. The significant expansion of bond offerings in international capital markets, sometimes termed the "securitization" of financial markets, has increased banks' incentive to enter the securities business. Tokyo recently allowed the securities subsidiaries of foreign banks to open branches in Japan, a prerogative still denied Japanese banks. If a foreign subsidiary of a Japanese bank were to gain the same right, that would end Japan's strict separation of investment and commercial banking.

The United States has encouraged Japan to develop a market in short-term securities analogous to the U.S. Treasury bill market. (Until now, almost all short-term notes have been sold to the Bank of Japan.) The development of such a market would help smooth out the debt-rescheduling process by broadening the maturity structure of government debt. Furthermore, it would accelerate the decontrol of interest rates, although Tokyo is reluctant to sacrifice the low-cost deficit financing that the present system allows. A short-term government bond market would also enable the central bank to replace current monetary policies with open-market operations.

The Finance Ministry's plans for such a market are said to be progressing and it expects to make its first offering of three- and six-month bills in the near future. Washington, however, is critical of several aspects of the program, including a 16 percent withholding tax, which will make the instrument less attractive to foreign investors, and the plan to limit the market to corporate investors.

One measure likely to increase the international use of the yen is the establishment of an offshore banking facility in Tokyo, an idea recommended by an advisory panel last September and approved by the cabinet last week. Such an establishment permits banks to operate without having to meet the regulatory and tax requirements of the country in which the facility is physically located. The Bank of Japan is thought to favor limiting the facility to commercial banking, as in New York, in order to minimize leakage from the domestic market that would complicate the conduct of monetary policy. Securities firms, of course, want the Tokyo facility to include investment banking as well, as in

London. In addition to increasing the use of the yen, offshore banking would help Tokyo compete with Hong Kong and Singapore as a world financial center. Observers say that offshore banking could be launched as early as this November.

For further information, contact Randall S. Jones.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Japanese Government Debt

(in trillions of yen)

Fiscal Year	Amount Issued	Amount Outstanding	Amount Outstanding as a Share of GNP
1972	Y1.95	Y5.82	6.0%
1973	1.77	7.55	6.4
1974	2.16	9.66	6.9
1975	5.28	14.97	9.8
1976	7.20	22.08	13.0
1977	9.56	31.90	16.9
1978	10.67	42.62	20.6
1979	13.47	56.25	25.3
1980	14.17	70.51	29.3
1981	12.90	82.27	32.3
1982	14.04	86.48	36.1
1983	13.49	109.70	39.4
1984	12.86	121.69	41.0

Source: Ministry of Finance

Table 2: Japan's Capital Account

(in billions of dollars)

Year	Net Long-Term Capital	Assets (Outflows)	Liabilities (Inflows)
1970	-$1.6	$2.0	$0.4
1971	-1.1	2.2	1.1
1972	-4.5	5.0	0.5
1973	-9.8	8.5	-1.3
1974	-3.9	4.1	0.2
1975	-0.3	3.4	3.1
1976	-1.0	4.6	3.6
1977	-3.2	5.2	2.1
1978	-12.4	14.9	2.5
1979	-12.6	16.3	3.7
1980	2.4	10.8	13.2
1981	-6.4	22.8	16.4
1982	-15.0	27.4	12.4
1983	-17.7	32.5	14.8
1984	-49.7	56.8	7.1

Source: Bank of Japan

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Worries Over Yen's Rapid Rise

The rapid rise of the yen against the dollar has aroused concern in Tokyo and at the Federal Reserve Board in Washington. A 6.2 percent jump in just six days of trading took the yen to Y178.8=$1.00 on February 19, its highest closing level since October 1978. Currency traders attributed the dollar's plunge below the Y180 level to U.S. Treasury Secretary James Baker's February 18 statement that the administration "would not be displeased to see a further orderly, gradual decline in the dollar."

The yen's rise was stemmed by comments by Japanese financial authorities, whose words have carried great weight in exchange markets during the past several months. A number of government officials have hinted at the possibility of intervention to stabilize the yen. On February 20 Bank of Japan governor Satoshi Sumita warned against too sharp an appreciation and expressed hope that more, Tokyo acted despite the opinion of many domestic and foreign analysts that Japanese firms can live with the Y180 exchange rate.

On a broader front, the government has been galvanized into action to stimulate domestic demand. In addition to recommendations from a private panel calling for an increase in wages and reduced savings incentives (see JEI Report No. 7B, February 21, 1986), the economic ministers are supporting changes in Japan's tax structure, an easing of monetary policy and increased government spending to offset the effects of the yen's rise. Although the Economic Planning Agency sees a healthy increase in consumer spending -- the major component of domestic demand -- this year, it expects activity in the manufacturing sector to slow, both in terms of current production and capital investment. If the economy does indeed lose steam, efforts to overhaul the nation's tax and regulatory structures may receive a big boost. At the very least, Japanese policymakers are in for a very busy year.

Jon Choy

Europeans Tune Down The Volume On Relations With Japan

The European Community has decided against hardening its position on overall trade relations with Japan despite a record bilateral 1985 trade deficit of just over $11 billion (see Table). At the same time, however, the Europeans agreed to continue to press Japan for specific changes in trade policy.

Japan's Trade With the European Community, 1984-85

(in millions of dollars)

	1984			1985		
	Exports	Imports	Balance*	Exports	Imports	Balance*
European Community	$19,405	$9,334	$10,071	$20,013	$8,887	$11,126
Great Britain	4,675	2,267	2,408	4,722	4,816	2,905
France	1,935	1,236	699	2,083	1,323	760
West Germany	6,622	2,684	3,937	6,937	2,924	4,014
Italy	1,032	1,049	-17	1,116	1,050	67

*Figures may not total due to rounding.

Source: Ministry of Finance

On February 6 the EC Commission submitted a set of proposals to the Council of Foreign Ministers calling for the following actions: negotiations on specific items; increased cooperation to encourage EC exports to Japan and Japanese investment in the continent; and the creation of an ad hoc committee to monitor items of concern and facilitate consultations. In addition, the package reiterates other familiar themes, including the setting of import targets by Japan and easier access to Japan's financial markets for European organizations.

At the urging of a group of businessmen two days earlier, the EC had called on Japan to lower domestic taxes and tariffs on alcoholic beverages. Criticizing the Japanese system as arbitrary, the EC called for a uniform tax and tariff system based on alcohol content -- the internationally accepted practice. The current Japanese system uses a more subjective three-class system to apply widely varying rates to imported and domestic drinks. European distillers and brewers claim that Japanese taxes on their exports were twice as high as European levies on similar Japanese products over the last two years. Further, Japanese import tariffs, they protest, are 170 percent to 620 percent higher than comparable European levies.

Capping these discussions, the 12 EC foreign ministers met February 17 and 18 to debate a report on trade policy toward Japan. While adopting the EC Commission's recommendations, the report extended an olive branch to Tokyo in the form of praise for Japan's efforts to move away from an export-dependent economic structure. Nevertheless, the EC is still waving a big stick at Japan by pursuing its claim at the General Agreement on Tariffs and Trade that Japan's low level of imported manufactured goods violates GATT principles. Even here, however, the EC is leaving the door open for individual members to take independent positions.

The foreign ministers were particularly interested in two of the commission's suggestions. Increased monitoring of Tokyo's progress toward implementing its July 1985 market liberalization program will be instituted and related programs aimed at trade in specific goods -- video cassette recorders and digital audio discs, for example -- will also be strengthened. The proposal to begin negotiations on improving access to Japan's market for specific European goods was also heartily endorsed. The EC undoubtedly hopes to duplicate the successful market-oriented, sector-selective (MOSS) talks between Japan and the United States.

The observation that ideology is not a factor when it comes to trade is supported by recent calls on Japan to reduce its trade surplus with Eastern European countries. The Comecon nations have had no more success in penetrating Japan's markets than their Common Market counterparts. Although Japan's surplus with Eastern Europe is a small fraction of Western Europe's ($247 million as opposed to $13 billion in 1985), even small imbalances can pose severe problems for foreign-currency-strapped communist countries. Japanese representatives have responded to earlier calls for action by citing the poor quality of steel and other products from Eastern Europe as the primary reason for the imbalance. Changing their tactics, the delegates to a Warsaw Pact trade conference expressed interest in promoting Japanese investment in basic industries (as opposed to high technology) and in obtaining Japan's help with sales of their merchandise in the third world, particularly Asia and Africa. Tokyo has yet to respond to these overtures.

Despite the persistent calls for action, Tokyo remains confident that things can be worked out. Unlike the United States, the European nations are not threatening Japan with strong protectionist actions. Trade expansion appears to be Europe's goal. Such an approach makes better economic sense, but may not reduce bilateral imbalances for many years.

Jon Choy

assistance for small and medium-sized firms (see article in this issue). This move may indicate that Japan is unwilling to make sacrifices in order to help correct the trade imbalance, he said.

- The U.S. Negotiating Stance - Despite the administration's "get tough" position, several legislators attempted to pin the USTR down on specific concessions wrought from Tokyo since September. Mr. Jenkins challenged the USTR to tell him what benefits the U.S. footwear industry gained from the resolution of the Section 301 investigation on leather and leather products, forcing Mr. Yeutter to acknowledge that the U.S. negotiating team got less market access for U.S. industry than it wanted (see JEI Report No. 1B, January 10, 1986). Maintaining that "we moved them as far as we could," Mr. Yeutter added that overall, the result of the talks on leather and leather products can be considered "very satisfactory" since it provided market concessions in other product areas, including aluminum.

Noting the fine line between tough negotiating and protectionism, Rep. Richard Gephardt (D, Mo.) said he was unconvinced that the administration was using the threat of closed U.S. markets as leverage to "change the behavior" of recalcitrant trading partners. Mr. Yeutter agreed on the need to help change national attitudes, saying "We [in the administration] have all pointed out that Japan must play a leadership role in world trade," but added that he was more than willing to use any kind of leverage provided by Congress or the executive branch. "My feeling is," said Mr. Yeutter, "that we need to pursue the Japanese on every front."

Sheri Hoptman

A Deluge Of Red Ink: The 1985 U.S. Trade Account

The final 1985 U.S. trade figures had all the makings of the lead story on the last day of January's newspapers and television news programs. Yet if the story of this country's mind-boggling trade deficit even rated front-page or network coverage, the news appeared below the fold or at the bottom of the broadcast. To business reporters and their editors, it appears, the $148.5 billion red-ink entry for 1985 (imports valued c.i.f.) was old news since that was almost exactly the same number Reagan administration policymakers had been working with since the 1984 trade deficit came in at $123.3 billion.

What journalists consider old news is still fresh political ammunition for congressmen pushing protectionist legislation -- no matter how many economic duds there are among the new bullets. And there are plenty. Exports did slip 2.2 percent last year to $213.2 billion after rallying 8.7 percent in 1984 from a two-year decline, but this drop was surprisingly small considering the impact of the high-flying dollar on the price competitiveness of U.S. suppliers overseas, the generally so-so economic performance turned in by other industrialized nations, the debt problems of many developing countries, and the scaled-back revenues of oil exporters. Likewise, while imports expanded 6 percent in 1985 to $361.6 billion, this gain was modest -- whether compared with the 26.4 percent jump in purchases that occurred two years ago or in terms of the slowdown in U.S. growth -- since the overvalued dollar gave foreign competitors a big edge in the American market.

U.S. Exports to Japan

(in millions of dollars, f.a.s. value basis)

	January-December 1984	January-December 1985	Percent Change
Total Exports	$23,575.0	$22,630.8	-4.0%
Industrial Supplies	9,139.2	8,679.9	-5.0
Bituminous Coal	865.4	769.1	-11.1
Petroleum Products	683.1	762.0	11.6
Natural Gas	262.3	249.1	-5.0
Nuclear Fuels	145.7	121.5	-16.6
Logs and Lumber	840.5	884.9	5.3
Paper Base Stocks	519.9	470.2	-9.6
Paper and Paper Products	290.0	288.9	-0.4
Organic Chemicals	717.1	704.0	-1.8
Inorganic Chemicals	836.4	801.9	-4.1
Plastics and Synthetic Resin Compounds	356.5	305.6	-14.3
Fertilizers and Insecticides	297.7	276.9	-7.0
Steel Scrap	264.9	199.1	-24.8
Nonferrous Ores and Scrap	363.8	459.6	26.3
Nonferrous Metals	378.9	289.4	-23.6
Textiles	112.8	107.5	-4.7
Raw Cotton	605.1	368.0	-39.2
Hides and Skins	325.2	298.2	-8.3
Leaf Tobacco	286.0	302.4	5.7
Capital Goods	5,626.6	5,938.6	5.6
Nonelectric Machinery	3,458.5	3,384.7	-2.1
Data Processing Equipment	1,166.2	1,331.1	14.1
Measuring, Testing and Control Instruments	445.5	448.7	0.7
Laboratory Testing and Control Instruments	93.6	104.5	11.7
Scientific, Professional and Medical Equipment	247.1	265.5	7.5
Power Generating Equipment (excl. aircraft and automotive engines)	307.5	73.3	-76.2
Metalworking Equipment	105.5	113.9	8.0
Service Industry Equipment	111.3	120.1	7.9
Electric Machinery	874.9	804.3	-8.1
Generators and Transformers	92.3	75.9	-17.8
Broadcast and Communications Equipment	416.7	327.1	-21.5
Telephonic and Other Electric Equipment	365.8	401.3	9.7
Transportation Equipment	1,293.2	1,749.6	35.3
Civilian Aircraft	541.4	905.9	67.3
Civilian Aircraft Engines and Parts	437.5	552.1	26.2
Automotive Parts	180.2	214.8	19.2
Food and Feed	5,929.2	5,000.7	-15.7
Corn	1,999.3	1,305.3	-34.7
Sorghum	269.8	242.9	-10.0
Soybeans	1,172.7	937.7	-20.0
Wheat	534.4	469.0	-12.2

Fruits and Vegetables	452.6	452.1	-0.1
Meat and Meat Products	571.0	540.8	-5.3
Fish and Fish Products	502.9	685.4	36.3
Consumer Goods	1,475.5	1,415.5	-4.1
Pharmaceuticals	571.8	590.5	3.3
Toys and Sporting Goods	89.3	79.7	-10.8
Cigarettes	95.4	94.9	-0.5

U.S. Imports from Japan

(in millions of dollars, Customs value basis)

	January-December 1984	January-December 1985	Percent Change
Total Imports	$57,135.0	$68,782.9	20.4%
Automotive Products	18,476.9	24,980.0	35.2
Cars	12,349.9	16,231.3	31.4
Assembled Trucks	2,912.0	4,311.6	48.1
Automotive Parts	3,205.6	3,938.4	22.9
Capital Goods	19,289.6	21,515.7	11.5
Nonelectric Machinery	12,891.9	14,448.9	12.1
Business Machines	6,414.6	6,274.1	-2.2
Metalworking Machinery	896.6	1,238.7	38.2
Specialized Industrial Machinery	1,480.6	1,323.1	-10.6
Scientific, Professional and Medical Equipment	477.1	670.0	40.4
Electric Machinery	6,029.4	6,542.6	8.5
Transportation Equipment	368.3	524.2	42.3
Consumer Goods	11,265.6	14,017.2	24.4
Video and Audio Recorders and Players and Stereo Equipment	3,756.7	5,280.1	40.6
Television Sets	684.3	827.7	21.0
Radio Receivers	285.5	306.9	7.5
Tableware and Glassware	408.8	442.8	8.3
Metal Cookware and Cutlery	403.5	438.3	8.6
Photographic and Optical Goods	1,038.0	918.5	-11.5
Clocks and Watches	437.6	479.9	9.7
Toys and Sporting Goods	412.2	563.8	36.8
Motorcycles and Parts	661.5	883.8	33.6
Clothing	494.0	487.3	-1.4
Intermediate Goods	7,275.6	7,035.3	-3.3
Steel Mill Products	3,149.9	3,048.3	-3.2
Nonferrous Metals	506.4	535.0	5.7
Organic Chemicals	514.7	564.1	9.6
Tires and Tubes	516.3	561.9	8.8
Textiles	671.0	715.2	6.6

However hard, it might be possible to persuade congressional supporters of protectionism that the stratospheric overall U.S. trade deficit does not necessarily constitute prima facie evidence of across-the-board unfair practices by this country's major trading partners. The chances of convincing them of the same thing when it comes to the U.S. imbalance with Japan are more remote, if only because the bilateral deficit bulged from $36.8 billion in 1984 to $49.8 billion last year (imports again valued c.i.f.). Yet if legislators take a close look at the figures, they might find some surprises that could change their perceptions of Japan as an unfair trader.

Sales to Japan did fall 4 percent in 1985 to $22.6 billion after posting back-to-back increases, but this decline largely reflected lower prices for bulk agricultural and industrial inputs. Manufactured products, in contrast, did almost uniformly well although they had to overcome the demand-dampening effects of the high dollar. Jet transports were just the biggest winners on a list that included computers and peripheral equipment, measuring and testing instruments, scientific and professional equipment, telecommunications equipment, aircraft engines and parts, automotive parts and pharmaceuticals.

There is also a thin silver lining to the import numbers. Purchases of Japanese-made products admittedly went up 19.9 percent to $72.4 billion, but this rate was only about half of 1984's. Moreover, two product groups alone provided most of the expansion. One, not surprisingly, was automotive products, particularly cars, which jumped by nearly one-third; the other, also not unexpectedly, was consumer electronics, especially video cassette recorders. Outside of these two areas, however, modest growth or no growth was generally the rule in 1985. In fact, purchases dropped in three of the top import groups -- steel, data processing equipment and other business machines, and specialized industrial machinery.

Susan MacKnight

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

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INTRA-FIRM TRADE AND U.S. PROTECTIONISM: THOUGHTS BASED ON A SMALL SURVEY

A STUDY BY JANE SNEDDON LITTLE OF THE FEDERAL RESERVE BANK OF BOSTON*

Summary

A significant share of U.S. imports represents purchases of finished products and parts by American multinationals from their offshore units or deliveries of components to the domestic manufacturing operations of foreign investors. Yet intra-firm transactions have received scant attention in the congressional debate over how to rein in the seemingly runaway U.S. trade deficit. In the following article, Jane Sneddon Little, an economist with the Federal Reserve Bank of Boston, explores the factors behind the expansion of trade between parent companies and overseas affiliates and outlines the implications of this overlooked development.

Introduction

Intra-firm trade -- trade between U.S. firms and their foreign affiliates or owners -- is playing an increasingly important but largely ignored role in U.S. international commerce. At least 35 to 40 percent of U.S. imports and exports move between members of the same firm as a growing number of industries take on global characteristics. Yet, in a year [1985] when the U.S. trade deficit is approaching $150 billion and members of Congress have introduced over 300 pieces of protectionist legislation, this sizable volume of intra-firm trade has attracted little or no comment or analysis.

*Reprinted from Federal Reserve Bank of Boston, New England Economic Review, January/February 1986.

One reason that intra-firm trade merits additional attention is that it may have reacted differently to recent exchange rate changes than did trade between unaffiliated firms. The 50 percent appreciation of the U.S. dollar which occurred between 1980 and early 1985 is considered a major cause of the deterioration of the U.S. trade balance. Whether intra-firm trade reacted differently from unaffiliated trade has consequences for the distribution of the costs and benefits of the adjustments required by the exchange rate change. If imports from unaffiliated firms were more sensitive to the dollar appreciation than imports from affiliates, say, then the dollar appreciation largely benefited unaffiliated foreign firms which expanded their exports to the United States and the U.S. users of these lower-cost imports. (The costs of adjustment were, of course, borne by U.S. producers of exports and import-competing goods.) On the other hand, if intra-firm imports rose faster than unaffiliated trade, then the products of U.S. multinationals accounted for a major part of the rise in imports caused by the dollar appreciation. To the extent that U.S. multinationals participated in expanding foreign production, they could protect their total output and earnings -- to the eventual benefit of their U.S. shareholders and even, conceivably, their U.S. employees.

As members of Congress come to deal with the piles of pending trade legislation, they need to know which U.S. industries and which U.S. trading partners are particularly involved in intra-firm trade. Where intra-firm trade plays an especially large role, pleas for protection may warrant an especially hard look.

This article will address these issues on the basis of information published by the U.S. Department of Commerce and a limited survey conducted by this author. The patterns that emerge indicate that intra-firm trade is indeed significant for many industries where import competition is causing concern. Moreover, although the growth of intra-firm trade has seemingly aggravated the deterioration of the U.S. trade balance, it probably also permitted the U.S. multinationals to make a relatively healthy adjustment to the strong dollar. Given the limited nature of the survey, however, many of these conclusions must remain tentative and require additional data for further testing.

Why Intra-Firm Trade Has Grown

Intra-firm trade, which generally follows the decision to produce abroad, tends to mature according to a typical pattern. As a first step, the parent frequently establishes a sales subsidiary or assembly plant to which the parent exports finished goods or components ready for final assembly. In the beginning, the foreign affiliate probably concentrates on selling to the host country market and then perhaps exports to third countries. If the parent acquires an ongoing firm in the host country, the new affiliate may continue to manufacture its own product line and may export some of that output through its new owner. Eventually, the foreign affiliate is likely to begin making some components of the parent's product for itself while continuing to import some crucial items from the home country. Finally, the affiliate may begin to export certain parts or products to the parent firm. Parent and affiliate may each specialize in particular items in order to reap the benefits of economies of scale.

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Although hesitant economic growth here and abroad slowed the rise in foreign direct investment (FDI) in the early 1980s, the U.S. FDI position abroad grew 25 percent between 1979 and 1984 (to $233 billion) while the foreign position in this country almost tripled (to $160 billion).[1] Increased FDI led to additional intra-firm trade.

For U.S. firms facing the very strong dollar and increased foreign competition, finding lower-cost production sites to protect domestic and foreign markets has undoubtedly become a primary motive for foreign investment. These motives were confirmed in a 1983 survey of 52 major international corporations, which indicated that the two main reasons that FDI increased during the 1982 recession were: 1) the momentum of investment plans and protection of existing market, and 2) an intensified search for lower-cost sources of production.[2]

Examples abound of U.S. firms trying to lower production costs by establishing a foreign plant and shipping its output to the United States. U.S. firms in industries such as electronics, textiles, drugs, automotive parts and toys have established 722 sister plants employing 202,000 workers in Mexico under the in-bond or "maquiladora" program. According to Mexican law, as long as the finished product is largely exported, U.S. investors may establish wholly owned assembly plants in specific but expanding areas, thereby gaining access to labor at one-seventh to one-eighth the U.S. cost, electricity at one-third of U.S. rates and various tax benefits.[3] Farther away, U.S. firms employ over half the 73,000 people working for electronics firms in Malaysia and have helped make that country the leading exporter of integrated circuits to the United States.[4] Similarly, all of the major U.S. auto companies have or are seeking joint ventures in Korea. General Motors, for instance, has formed a joint venture with the Daewoo Group to produce 167,000 cars a year in Korea by 1987. About half of these cars are destined for export, including shipment to the United States for distribution by Pontiac.[5]

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[1] U.S. firms' continued interest in foreign production is possibly better illustrated by the growth of their equity in their incorporated foreign affiliates. The equity position grew $54 billion or 39 percent between 1979 and 1983. This growth was partially camouflaged in the net position figures by U.S. parent borrowings of $32 billion from their incorporated affiliates. The debt reflected comparatively low interest rates abroad, tax considerations and the expectation that the dollar would continue strong.

[2] The Office of The Group of Thirty, Foreign Direct Investment, 1973-82: A Survey of International Companies, New York, Group of Thirty, 1984, p. 21.

[3] Bill Mongelluzo, "In-Bond Program Expands Beyond U.S. Mexico Border," The Journal of Commerce, June 10, 1985, p. 1A.

[4] Barbara Crossette, "Malaysian High-Tech Industry," The New York Times, July 8, 1985, p. D4, and "Electronics Firms Bullish in Malaysia," The Journal of Commerce, April 23, 1985, p. 1A.

[5] Susan Chira, "South Korea's Auto Industry: Analysts Split on Outlook," The New York Times, July 9, 1985, p. D1.

Apparel makers are not typical high-tech, oligopolistic foreign investors, but they too are increasingly manufacturing abroad for the U.S. market in order to take advantage of wages plus fringe benefits that range from 30 cents an hour in China to $2.05 an hour in Hong kong (compared to $6.50 per hour in this country). Accordingly U.S. retailers and clothing manufacturers have begun "island hopping" to find places with low wages, investment incentives and no U.S. quotas. Moreover, some firms are taking advantage of a provision in the U.S. Tariff Schedule which allows companies to cut fabric in the United States, assemble the goods in Caribbean Basin countries, and reimport the final product to the United States while paying duty only on the labor and not on the domestic materials.[6]

If U.S. firms are expanding abroad because of the strong dollar, foreign firms clearly are continuing to rush into the United States despite the dollar appreciation. Their continuing expansion reflects foreign investors' optimism about the relative strength of the U.S. economy over the long term, the comparative attractiveness of this country's social and political climate, fear of the rising tide of protectionism in this country (particularly on the part of Japanese investors), and the ability to service the U.S. market better from a U.S. location.

As an example of this last motive, Dynamit Nobel Silicon, an Italian producer of silicon chips, is establishing a factory in South Carolina because "producing in the United States is a necessary choice for anyone who wants to significantly increase sales to American electronics companies. . . . For our customers the distance between Italy and California is such that [U.S. firms] do not want to get any more than 10 percent of their needs from us."[7]

Where Intra-Firm Trade Plays an Important Role

The U.S. Department of Commerce's periodic surveys of FDI provide a considerable amount of information on the importance and the industrial and geographic structure of intra-firm trade. Although the data are not highly current, they suggest that intra-firm trade plays a significant role in some of the industries threatened by import competition. Intra-firm transactions also account for a large share of U.S. imports from several of the countries singled out in pending trade bills.

Because the benchmark surveys on inbound FDI are for different years from the surveys on outbound FDI, it is unfortunately not possible to make direct comparisons of the behavior of foreign and U.S. multinational corporations.[8] However, assuming that the shares of U.S. trade accounted for by

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[6] Steve Weiner, "Rules Force Retailers, Importers into Survival by Island-Hopping," and Hank Gilman, "More Apparel Makers Turn Abroad," The Wall Street Journal, May 9, 1985, p. 6.

[7] David Fleming, "Dynamit Nobel Silicon Pins Hopes on U.S. Move," The Journal of Commerce, December 17, 1984, p. 23B.

[8] The latest published benchmark surveys are U.S. Bureau of Economic Analysis, U.S. Direct Investment Abroad, 1977, April 1981, and Foreign Direct Investment in the United States, 1980, October 1983. The BEA is currently

U.S. multinationals in 1977 and by U.S. affiliates for foreign multinationals in 1980 remained approximately the same during that period, then intra-firm trade amounted to roughly 35 percent of U.S. exports and 40 percent of U.S. imports in the 1977-80 period.

As shown in table 1, the U.S. multinationals' intra-firm trade as a share of total U.S. trade increased considerably between 1966, the date of the previous benchmark survey, and 1977. By contrast, in the case of the U.S. affiliates of foreign multinationals, their intra-firm trade as a share of total U.S. trade changed very little between 1974 and 1982. Without up-to-date information -- especially on the U.S. parents' intra-firm trade -- it is hard to conclude from the official figures whether intra-firm trade is increasing in importance. Anecdotal evidence and the survey results reported in the next section certainly suggest that it is, however.

The dated benchmark figures also show some of the industries and the geographic areas in which intra-firm trade has played an especially large role. As table 2 indicates, intra-firm trade accounted for a significant share of total U.S. imports in many import-sensitive industries, if once again 1977 and 1980 data can be juxtaposed. For instance, intra-firm imports represented over 60 percent of U.S. imports of industrial chemicals and synthetics, nonelectrical equipment (including office and computing machines), and printing and publishing; half of U.S. imports of construction and related equipment and electronic components; one-third of U.S. imports of drugs and soap, cleaners and toiletries; and one-quarter of U.S. imports of fabricated metal products. Several of these industries are widely considered prime examples of sectors threatened by import competition. Unfortunately, for a few other industries of interest, the data are not available. (The appendix table provides additional data on intra-firm trade as a share of parent (or affiliate) total trade by industry.)

As for geography, table 3 shows for which trading partners intra-firm trade was especially important in 1977 and 1980. Among the developed countries, Canadian and British affiliates of U.S. multinationals produced particularly large shares of their countries' exports to the United States. As for the developing countries, moreover, the intra-firm exports of U.S. affiliates in Hong Kong, the "Other Western Hemisphere" (which includes the Caribbean countries), and Singapore accounted for a full 50 to 80 percent of this country's total imports from those areas in 1977.

Although the intra-firm trade of U.S. multinationals has not played a big role in this country's imports from Japan, Germany or the Netherlands, the intra-firm trade of Japanese, German and Dutch affiliates in the United States accounted for 40 to 60 percent of U.S. imports from those three countries. If the shares seen in 1977 can be assumed to have remained roughly constant through 1980, then 70 percent of U.S. imports from Japan and half of U.S.

([8]continued) working on the 1982 benchmark survey on FDI abroad which will be published in late 1985. The BEA also provides Foreign Direct Investment in the United States: Annual Survey Results which includes some intra-firm trade data. Starting with 1983 figures, the BEA will also publish annual information on outbound FDI and the trade between U.S. multinationals and their affiliates.

Table 1

Intra-Firm Trade as a Percentage of Total U.S. Trade[a]

	U.S. Parent	
	Exports to Foreign Affiliates	Imports from Foreign Affiliates
1966	17.6	11.0
1977	26.7	21.7

	U.S. Affiliate	
	Exports to Foreign Parent Group	Imports from Foreign Parent Group
1974	11.9	20.9
1980	9.5	19.2
1981	11.5	20.5
1982	11.4	21.5

[a] Census basis

Sources: U.S. Bureau of Economic Analysis, *U.S. Direct Investment Abroad, 1966 and 1977*; *Foreign Direct Investment in the United States, 1980* and Vol. 2, *Benchmark Survey, 1974*; *Foreign Direct Investment in the United States: Annual Survey Results, 1981 and 1982*; *Survey of Current Business*, various issues.

Table 3

Intra-Firm Imports as a Percentage of Total U.S. Imports from Selected Countries, 1977 and 1980

	U.S. Parent Intra-Firm Imports, 1977	U.S. Affiliate Intra-Firm Imports, 1980
Canada	37.8	12.1
Japan	4.8	63.2
European Community	14.9	33.9
France	n.a.	34.7
Germany	10.8	53.1
Italy	4.0	16.2
Netherlands	10.2	38.9
United Kingdom	26.7	20.6
Other Europe	20.4	46.5
Latin America	23.3	6.3
Brazil	13.2	7.6
Mexico	12.9	1.9
Other Western Hemisphere	73.0	5.0
Other Asia and Pacific	10.4	9.6
Hong Kong	54.2	4.9
Philippines	14.6	9.8
Singapore	80.0	n.a.
Taiwan	n.a.	11.3
Malaysia	n.a.	10.4
South Korea	n.a.	11.9

n.a. = not available

Source: U.S. Bureau of Economic Analysis, U.S. Bureau of the Census, and the International Monetary Fund.

Table 2

Intra-Firm Imports as a Percentage of Total U.S. Imports, Selected Industries, 1977 and 1980

	U.S. Parent Intra-Firm Imports, 1977	U.S. Affiliate Intra-Firm Imports, 1980
All Industries	22	20
Petroleum	31	4
Manufacturing	18	5
Food & Kindred Prods.	d	4
Beverages	d	14
Chemicals & Allied Products	23	20
Industr. Chems. & Synths.	38	24
Drugs	n.a.	16
Soaps, etc.	d	37
Primary & Fab. Metals	14	6
Primary Metals	11	7
Fab. Metal Prods.	23	3
Machinery, except Elec.	55	9
Construction & Rel. Equip.	34	13
Office & Computing Equip.	d	d
Elec. & Electronic Equip.	23	12
Radio, T.V. & Communic.	d	8
Electronic Components	43	9
Motor Vehicles and Equip.	d	d
Textiles & Apparel	d	1
Lumber, Furn. & Fixtures	4	2
Printing & Publishing	53	10
Stone, Clay & Glass	15	4
Instruments & Rel. Prods.	9	5

d = data withheld to prevent disclosing information about individual firms

n.a. = not available

Source: U.S. Bureau of Economic Analysis and U.S. Bureau of the Census.

imports from Canada and the European Community were intra-firm in character. While intra-firm trade generally played a lesser role in U.S. trade with the developing countries, for some Southeast Asian and Caribbean countries the intra-firm trade share was roughly 60 to 80 percent.

Table 4 lists the countries that had the largest trade surpluses with the United States in 1984 and indicates which would be subjected to the 25 percent surcharge on all imports proposed in the Bentsen-Gephardt-Rostenkowski bill.[9] If the intra-firm trade shares for 1984 were similar to those for 1977-80, then intra-firm imports were significant in almost all cases. Although data for Taiwan and Korea are not fully available, it seems likely that intra-firm trade plays a considerable role there as in other Southeast Asian countries.

Table 4

Countries with the Largest Trade Surpluses versus the United States in 1984

Billions of Dollars	
Japan[a]	36.8
Canada	20.4
Common Market	13.3
Taiwan[a]	11.1
Mexico	6.3
Hong Kong	5.8
Brazil[a]	5.6
South Korea[a]	4.0

[a] Countries that would be subject to a 25 percent surcharge on imports according to the Bentsen-Gephardt-Rostenkowski bill

Source: U.S. Department of Commerce

Does Congress really want to restrict U.S. multinationals' imports from their foreign affiliates? Perhaps so, since foreign affiliates are generally manned by foreign labor at the apparent short-run expense of workers in this country. Nevertheless, these imports have also permitted U.S. firms to weather the strong dollar and ferocious foreign competition in better shape than they would have without them. Do U.S. voters want to thwart U.S. affiliates of foreign multinationals from importing the parts they need to thrive and provide employment in this country? At least these questions deserve current data and more discussion.

[9] The Bentsen-Gephardt-Rostenkowski will would impose a 25 percent surcharge on imports from countries whose exports to the United States and the world exceeded their imports from these areas by certain percentages, if the U.S. Trade Representative determined these nations had unfair trade barriers. The surcharge would be waived if the surpluses were reduced by specified percentages over a given time period.

Survey Results

In an effort to collect some clues about recent multinational behavior and to develop a short time series for examining the impact of exchange rate changes on affiliated versus unaffiliated trade, the author conducted a survey of New England firms. The survey went to 475 firms which had identified themselves as being active in international commerce or which were foreign-owned firms with a known mailing address.[10] One hundred four companies responded (a 22 percent response rate) without any follow-up to solicit additional replies.[11]

Of the 104 responses, 57 firms were multinationals. Eighteen of these firms were foreign-owned and 39 were U.S. firms with foreign affiliates. (Of course, not all of these respondents answered the survey fully.) All the countries known to be important sources and recipients of FDI were well represented.[12]

For both foreign firms coming to this country and U.S. firms investing abroad, the survey results suggest considerable current FDI activity. Of the 16 foreign affiliates that provided a date for the beginning of foreign ownership, 10 were established in 1979 or later. Moreover, 26 U.S. firms had set up 28 new affiliates since 1979. This intense activity occurred despite the 1982 recession, continuing weakness abroad, and the huge appreciation of the dollar.

[10] The firms had identified themselves as being active in international commerce by their membership in the International Business Center of New England or by designating themselves as foreign traders in the Directory of New England Manufacturers. Since we selected manufacturing members of the IBC and relied on the Directory just mentioned, the U.S. firms were mostly large and mid-sized manufacturers. The foreign firms were identified through a U.S. Department of Commerce, International Trade Administration annual publication entitled Foreign Direct Investment in the United States: 1983 Transactions (and earlier issues), and from lists developed for the IBC. The foreign-owned firms were not necessarily manufacturers and were included regardless of size.

[11] No effort was made to solicit additional replies once it became clear that the original research plan would not fit the data supplied. The original intent was to develop a data set of matched pairs. The matched pairs were to include each respondent's exports (imports) with its affiliate in a chosen country and with all residents of the same country. Because, for psychological reasons or legal commitment, many firms channel all or most of their trade with a given country through their affiliate there, in about half the cases the respondents supplied a single number where we had expected a matched pair.

[12] Among the foreign-owned firms, Swiss, German and English investors predominated while investors from Austria, Canada and the Netherlands were also represented. Their major affiliates were in Canada (6), the United Kingdom (5), Germany and Switzerland (4 each), Japan (2) and France, Austria and Hong Kong (1 each). The U.S. multnationals identified major affiliates in the United Kingdom (11), Canada (9), Germany (8), Japan (6), Holland (4), France (3), "Europe" (3), and one each in Australia, Switzerland, Belgium, Costa Rica, Brazil, Taiwan and the Dominican Republic.

Among the firms responding to the survey, the typical multinational corporation conducted over half of its trade within its own firm in 1983. For the U.S. respondents the mean share of intra-firm exports in total exports was 50 percent while the mean share of intra-firm imports in total imports was 58 percent. For the typical U.S. affiliate of a foreign firm 44 percent of exports were intra-firm while 70 percent of imports represented affiliate trade.

Survey recipients were asked to supply figures for 1979 through 1983 for their intra-firm exports to their two major affiliated customers and for their total exports to the same two countries. Similarly, they also provided intra-firm import figures for their two major affiliated suppliers along with data on their total imports from the same two countries.[13] From these data it appears that the respondents' intra-firm trade with major affiliates grew much faster between 1979 and 1983 than did their total trade with the same countries. Total exports to important affiliates rose 35 percent between 1979 and 1983 while total exports to the same countries rose 19 percent. Similarly, total imports from major affiliates surged 279 percent during that period while total respondent imports from the same countries grew 56 percent.[14]

A major question motivating this survey was whether intra-firm trade reacts "differently" from unaffiliated trade to macroeconomic developments such as exchange rate changes. Because intra-firm trade is potentially "managed" trade, it seemed possible that the pace or size of its adjustment would differ from that of trade between unaffiliated firms. Presumably, foreign affiliates add to a firm's flexibility and permit it to shift production locations between parent and various subsidiaries more rapidly than would be likely to occur when adjustment involved unaffiliated firms. In the latter case, the firms would not only have no reason to cooperate but some would actively resist any change. If so, intra-firm trade might be more sensitive to macro developments than unaffiliated trade. On the other hand, because affiliates sometimes depend on each other for parts, have commitments to purchase a fixed quantity of a product, or have more opportunities for hedging, intra-firm trade might be less sensitive to changing economic conditions.

Accordingly, survey recipients were asked whether the firm had ever shifted production sites because of an exchange rate change. Four of 28 U.S. firms said "yes," and another indicated that it was considering such a move.

[13] As already mentioned, in 54 out of 100 cases, all trade with a chosen country was channeled through an affiliate.

[14] We also calculated the annual percent changes for affiliate exports and imports and for the corresponding total firm exports and imports with the same countries. We then tested to see whether the means of these matched pairs of data (affiliate versus total exports or imports in the same country) were significantly different from each other. We examined all export observations, all import observations and observations for the United Kingdom, Canada and Germany, the countries with the largest number of affiliates. Only in the case of U.K. imports was the mean annual percent change in affiliate trade significantly different from the mean annual percent change in total trade at the 5 percent significance level. The mean annual change in imports from U.K. affiliates was 59 percent while the mean annual change in imports from the United Kingdom was 14 percent.

Three of the positive replies mentioned a shift away from the United States while two involved transfers between other countries. In other words, one-tenth of the U.S. respondents to this question in our very small survey were willing to move production out of the United States because of the dollar appreciation.

The data provided by the survey respondents also suggest that intra-firm trade reacted to macro developments differently than did unaffiliated trade between 1979 and 1983. As table 5 shows, the respondents' intra-firm exports and imports both grew faster than total U.S. trade weighted according to the industries represented in the survey group.[15] As we saw earlier, however, many of the affiliates were established quite recently. As they expanded their trade from very low levels, phenomenal percentage increases in the trade data could result. Even when the impact of start-up situations is excluded, however, ongoing intra-firm imports still grew almost three times as fast as total U.S. imports (which include start-ups). By contrast, ongoing intra-firm exports grew substantially less than total U.S. exports in the same industries. Finally, trade with unaffiliated firms in countries with major affiliates both declined a considerable amount over those years.

Table 5

Growth in Survey Respondents' Trade and Comparable U.S. Trade from 1979 to 1983

Percent

U.S. Imports[a]	51.4
Respondent Imports from	
Countries with Major Affiliated Suppliers	55.8
Affiliates	279.1
Affiliates, excluding Start-Ups	150.3
Unaffiliated Suppliers in the Same Countries	−98.7
U.S. Exports[a]	23.7
Respondent Exports to	
Countries with Major Affiliated Customers	18.6
Affiliates	34.6
Affiliates, excluding Start-Ups	11.5
Unaffiliated Customers in the Same Countries	−22.5

[a] Weighted average of industries represented in respondent group.

Source: Author's survey and *Survey of Current Business*.

In appears, thus, that even without start-up activity the respondents' intra-firm imports grew faster than total U.S. imports in the context of the dollar appreciation, as multinationals began to obtain abroad parts or product lines for use in the United States. Seemingly, some of that intra-firm import growth was at the expense of unaffiliated suppliers in affiliate countries, whose imports to U.S. multinationals grew slowest of all the groups examined.

[15] Survey group trade was heavy on electrical and nonelectrical machinery, instruments, chemicals, and transportation equipment other than motor vehicles.

Because of start-up activity, the respondents' intra-firm exports also grew faster than comparable U.S. exports. Without start-ups, intra-firm exports did not grow as fast as total U.S. exports in the same industries, but they still performed much better than the respondents' declining exports to unrelated firms in the same countries. Intra-firm exports undoubtedly held up relatively well, in the face of the strong dollar, because the affiliates expanded production to serve the local or third-party markets and required additional inputs from the United States. Again, some of these exports to affiliates replaced exports to unaffiliated third parties in the same country. Altogether then, between 1979 and 1983, these respondents' affiliate imports appeared more sensitive to the dollar appreciation and relatively weak economic conditions abroad than were total U.S. imports, while intra-firm exports were less sensitive than total U.S. exports.

Implications

If the few New England firms which answered the survey are at all representative of U.S. multinationals in general -- and they very well may not be -- then it would appear that the growth of FDI and intra-firm trade may have increased the sensitivity of U.S. imports to a dollar appreciation while dampening the sensitivity of U.S. exports. Because the increase in import sensitivity appears greater than the decrease in export sensitivity, the growth in intra-firm trade may have aggravated the U.S. trade deficit in recent years. (Of course, it is possible that multinational corporations merely react faster than other traders and that the ultimate adjustment of the U.S. trade balance to the dollar appreciation will be no different because of their activities.)

However, the multinationals can hardly be criticized for expanding foreign production and increasing imports from abroad, two normal and expected reactions to any dollar appreciation; moreover, because U.S. multinationals can participate both in raising foreign production and in increasing U.S. imports, they are able to maintain larger shares of output and sales than they would if they did not operate abroad. Their healthy adjustment to the dollar appreciation is in the interest of their owners and, conceivably, their U.S. employees as well. Because most foreign affiliates rely on inputs from their U.S. parents, the U.S. multinationals' foreign expansion has probably helped maintain U.S. output at a higher level than it would have been otherwise. In addition, firms better able to maintain their output and earnings are also better able to invest in research and product development -- activities which involve U.S. labor in particular.

As domestic firms have become less and less able to compete with foreign producers, U.S. multinationals have increasingly joined the foreign competition. This muddled state of affairs is likely to alter the politics of domestic and international trade negotiations considerably. In particular, it is unlikely that the U.S. public will or should react to requests for import relief with equal urgency when a significant part of the "injurious" imports are known to represent the output of U.S. firms abroad or are required by sought-after foreign investors providing jobs in this country. (Of course, domestic firms requiring imports could make exactly the same point.)

Naturally, the political pressures on decision-makers will also become more diffuse because of the growing dichotomy between "have" and "have not" U.S. firms. For instance, one U.S. firm with no Japanese affiliates recently filed an anti-dumping petition against Japanese producers and is seeking the imposition of import duties on their chips. By contrast, the U.S. firms with Japanese affiliates are supporting a Semiconductor Industry Association effort to improve access to the Japanese market.[16]

One positive consequence of the shifting alliances accompanying the growth of intra-firm trade may, thus, already be emerging -- even amid the generalized clamor for more protection from foreign competition. It seems that as more and more U.S. firms produce abroad, demands for erecting specific U.S. trade barriers may become less persuasive while pressures for dismantling foreign trade restrictions may intensify. As an example, the Bentsen-Gephardt-Rostenkowski bill already mentioned would only apply to nations with "unfair" trade barriers. Any resulting reduction in trade distortions would, of course, be a net gain for the world economy.

Conclusion

Although public discussion of the huge U.S. trade deficit largely ignores intra-firm transactions, they actually play a major role in U.S. trade. This observation particularly applies to several of the industries and trading partners specified in the protectionist legislation pending before Congress. Accordingly, as policymakers debate the many trade bills before them, they may want to devote more attention then they have in the past to the significance and consequences of intra-firm trade. Indeed, just airing the idea that a considerable share of U.S. imports represents the output of U.S. multinationals or the inputs required by foreign (and domestic?) investors providing jobs for U.S. workers may ease public frustration with our seemingly intractable trade problems.

Because the survey results reported in this article are based on a small group which may not be at all representative of other U.S. firms, it must be stressed that any conclusions based on these responses are highly tentative and require further testing. Nevertheless, the survey results at least provide some provocative clues about these intra-firm trade issues.

From the data supplied by the survey respondents, it appears that U.S. intra-firm trade increased its share of U.S. international commerce between 1979 and 1983. Moreover, during that period U.S. intra-firm imports were more sensitive to the appreciation of the dollar than were unaffiliated imports, largely because U.S. multinationals were establishing lower-cost production sites abroad to protect domestic markets from foreign firms' competition. By contract, U.S. intra-firm exports were less sensitive to the appreciation of the dollar than were unaffiliated exports -- again largely because U.S. multinationals expanding abroad required supporting exports from the United States. Finally, the increased sensitivity of U.S. intra-firm imports to the dollar appreciation more than offset the decreased sensitivity of U.S. intra-firm exports between 1979 and 1983; thus, on balance, the growth of intra-firm trade apparently aggravated the deterioration of the U.S. trade balance at that time.

If further data and testing confirm these tentative conclusions, one additional conjecture emerges: because U.S. multinationals can easily participate in two expected adjustments to a dollar appreciation -- increased foreign production and rising U.S. imports -- they can make a comparatively healthy adjustment to the strong dollar. They should not require protection against import competition for their survival.

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[16] Eduardo Lachica, "Micron Files Petition Against Japanese Firms," The Wall Street Journal, June 28, 1985, p. 26.

* * * * * *

Appendix Table

Intra-Firm Trade as a Percentage of Parents' (Affiliates') Total Trade, by Industry

	U.S. Parents, 1977		U.S. Affiliates, 1980	
	Imports	Exports	Imports	Exports
All Industries	41.9	34.7	62.0	40.2
Mining	d	d	89.3	36.9
Petroleum	39.7	36.3	26.3	60.4
Manufacturing	56.1	41.9	75.0	29.2
Food & Kindred Products	d	21.9	48.9	20.3
Grain Mill & Bakery Products	d	d	d	d
Beverages	52.7	d	79.6	d
Other	d	d	d	d
Chemicals & Allied Products	35.4	45.0	79.5	38.6
Industrial Chemicals & Synthetics	40.2	40.4	90.5	37.7
Drugs	41.6	74.8	81.8	71.4
Soaps, Cleaners & Toiletries	d	55.0	56.4	58.5
Agricultural Chemicals	d	d	d	d
Other	39.5	d	d	d
Primary & Fabricated Metals	38.5	24.1	71.3	27.9
Primary Metals	36.0	21.0	71.2	31.6
Ferrous	22.1	9.8	74.0	23.9
Nonferrous	49.2	29.9	70.6	33.8
Fabricated Metal Products	46.1	29.6	71.5	12.2
Machinery, except Electric	58.6	42.1	88.4	28.4
Construction & Rel. Machinery	42.2	23.4	73.9	20.4
Special Industry Machinery	n.a.	n.a.	92.6	18.5
Office & Computing Machinery	d	81.0	d	19.0
Other	66.4	d	d	47.5
Electric & Electronic Equipment	60.3	34.5	90.2	40.5
Household Appliances	d	31.3	n.a.	n.a.
Radio, T.V. & Commun. Equipment	d	41.0	93.9	d
Electronic Components	93.7	63.8	76.2	30.3
Other	d	21.0	96.5	d
Transportation Equipment	d	50.2	57.0	7
Motor Vehicles & Equipment	d	75.1	d	9
Other	35.1	7.5	d	4
Other Manufacturing				
Tobacco	d	d	n.a.	n.a.
Textile Products & Apparel	d	30.1	67.3	40.0
Lumber & Furniture	37.8	8.0	76.5	21.2
Paper & Allied Products	d	39.8	d	43.3
Printing & Publishing	55.7	46.3	43.7	32.9
Rubber Products	d	40.6	67.5	27.9
Misc. Plastics Products	d	36.6		
Glass Products	d	28.2	70.4	14.8
Stone, Clay, Cement & Concrete	70.0	25.6		
Instruments & Related Products	38.9	65.3	86.9	39.1
Other	22.7	d	d	35.2
Wholesale Trade	7.5	8.2	66.8	42.4
Motor Vehicles & Equipment	5.7	5.2	d	d
Metals & Minerals			42.0	44.3
Other Durable Goods			88.9	55.7
Nondurable Goods	12.6	8.8	d	d
Retail Trade	25.1	66.1	37.2	20.6

d = data withheld to prevent disclosing information about individual firms

n.a. = not available

Source: U.S. Bureau of Economic Analysis, *U.S. Direct Investment Abroad, 1977* and *Foreign Direct Investment in the United States, 1980*

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JEI

REPORT

NO. 10B
March 14, 1986

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Japan Cuts Discount Rate Second Time In Five Weeks

Japan joined the international round of central bank interest rate cuts by lowering its official discount rate 0.5 percentage point to 4 percent on March 7. The drop in the discount rate, the rate the Bank of Japan charges on loans to commercial banks, was intended to offset the deflationary impact of the yen's rapid appreciation on the Japanese economy. The rate had been the strong yen to pass on any savings to customers; encouraging management to grant larger wage increases in this year's labor negotiations; and a more flexible monetary policy.

The Japanese business community is also calling for some kind of governmental response to the yen's rise, with deregulation, public works and tax cuts leading the list of options. The president of the Japan Chamber of Commerce and Industry wants Tokyo to lift restrictive regulations in the housing, railroad and retail sectors to encourage private investment. He has cited such projects as a bridge across Tokyo Bay and a new airport near Osaka, each worth $5.5 billion, as domestic demand expanders. To offset the expected decline in capital investment due to falling profits, the chorus calling for major business tax cuts is growing. While Japanese industry has often claimed that the tax-to-profit ratio is twice as high in Japan as in the United States, Ministry of Finance officials have cold-shouldered the idea of a major revision of the tax system in FY 1986.

There appears to be a wide gap between those who advocate swift remedial action and those who urge patience in responding to the effects of a strong yen. This atmosphere of indecision is likely to continue as long as the yen remains unstable and the economy sends conflicting signals. With the Tokyo summit of industrial nations approaching and continued restiveness among Japan's major trading partners, the government is likely to act more for political reasons than economic. Whether or not this will result in good policy is unclear.

Jon Choy

Yen Up Sharply Against Third-Country Currencies

Although the yen-dollar exchange rate has been in the spotlight, the yen has also appreciated against the currencies of Japan's other important trading partners. Weighted by trade with Japan's 14 largest trading partners, the yen has risen more than 42 percent during the past year and almost 31 percent since last September (see Tables). The appreciation of the yen against most other Asian currencies has matched or exceeded its rise against the dollar.

The yen's sharp advance is already beginning to affect trade flows. Korea, where imports of Japanese machinery have climbed by an average 20 percent annually in recent years, is planning to reduce its dependence on imports. The country's three major auto makers have established special task forces to increase local content. In addition, the shipbuilding industry, which meets about 40 percent of its parts requirements with imports from Japan, plans to purchase more from domestic suppliers. The appreciation of the yen may enable U.S. producers to reduce Japan's 60 percent share of Korea's machinery imports, although previously these efforts have been largely unsuccessful because many industries are geared to Japanese models and specifications.

The rise of the yen will also make it more difficult for Japanese products to compete in the United States and other foreign markets. Korean manufacturers, particularly in the area of consumer electronics, hope to

Japan's Major Trading Partners, 1985

(in millions of dollars)

Country	Two-Way Trade	Exports	Imports
1. United States	$91,068	$65,290	$25,778
2. China	18,960	12,478	6,482
3. Saudi Arabia	14,134	3,890	10,244
4. Australia	12,831	5,378	7,453
5. Indonesia	12,286	2,169	10,117
6. Korea	11,202	7,094	4,108
7. United Arab Emirates	10,079	1,163	8,916
8. West Germany	9,859	6,936	2,923
9. Canada	9,281	4,519	4,762
10. Taiwan	8,409	5,024	3,385
11. Hong Kong	7,278	6,511	767
12. United Kingdom	6,538	4,722	1,816
13. Malaysia	6,476	2,168	4,308
14. Singapore	5,452	3,860	1,592
Total	223,845	131,202	92,643
Share of Japan's Total Trade	73.4%	74.7%	71.5%

Movement of Yen Against Currencies of Major Trading Partners

Country	February 25, 1985 to February 24, 1986	September 16, 1985 to February 24, 1986
1. United States	44.0%	32.0%
2. China	62.8	43.1
3. Saudi Arabia	46.7	32.0
4. Australia	41.9	26.9
5. Indonesia	47.0	32.0
6. Korea	52.2	32.4
7. United Arab Emirates	44.0	32.0
8. West Germany	-5.3	4.0
9. Canada	42.7	33.1
10. Taiwan	44.0	32.0
11. Hong Kong	44.0	31.7
12. United Kingdom	2.6	19.5
13. Malaysia	38.3	31.8
14. Singapore	35.6	25.6
Weighted Average	42.4	30.9
Weighted Average Without Dollar	41.3	30.2

increase their sales in this country as Japanese products become more expensive. According to the Korea Development Institute, an exchange rate of Y180=$1.00 would add 1 percentage point to Korea's growth rate during the coming year and increase exports to this country by 7 percent. Moreover, industries such as steel hope to continue to expand their market share in Japan.

It is also clear from the table that the dollar has failed to appreciate substantially relative to the currencies of many important Asian nations (see JEI Report No. 9B, March 7, 1986). Despite the dollar's depreciation relative to the yen and some European currencies, it must decline relative to other currencies in order to substantially reduce the U.S. trade deficit.

Randall S. Jones

Quiet Diet Tackles Ticklish Topics

Despite a week-long disruption over domestic tax issues, the current regular session of the Diet has proceeded rather smoothly and without the usual dramatics over such issues as defense spending. Nevertheless, Diet members have not yet tackled many of the serious issues remaining from the previous regular and special sessions, several of which are critical to Japan's political situation.

The most important item on the agenda -- the FY 1986 budget -- was approved by the lower house March 10 along strictly partisan lines, with the ruling Liberal Democratic Party-New Liberal Club coalition outweighing opposition party votes. The budget will proceed to the upper house, where prompt approval is anticipated in time for the beginning of the new fiscal year April 1.

In the past, the budget has precipitated Diet debates over defense that have largely focused on cosmetic or symbolic issues while failing to address many of the fundamental policy implications of military outlays. Much of last year's debate centered solely on the intentions of the Nakasone cabinet to hold total defense spending to one percent of the gross national product. The 1986 budget deliberations, while lacking much of the drama of previous years, were widely applauded by editorial observers for their forthrightness and candor. While some concern, for example, was raised over statements by defense director general Koichi Kato that Japanese Self-Defense Forces would, as a matter of course, aid American military vessels outside of Japan's territorial waters, the general reaction in Japan was one of approval, both of the policy and of Mr. Kato's approach to the issue. The spending totals projected in the Japan Defense Agency's new five-year program had few critics -- defense opponents apparently were satisfied by last fall's intra-party debate over retention of the one percent spending limit.

The Nakasone government is working on plans to reorganize the Japanese National Railways into eight separate, private companies and is expected to introduce implementing legislation in the immediate future. JNR's first proposals to transfer redundant employees within JNR or to the private sector have been announced, part of an anticipated drive to find new employment for the 61,000 excess workers in the present system. The bills (five separate

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AT A CROSSROADS: FOREIGN BANKS IN JAPAN

Summary

Japan's banking market is both a dream and a nightmare. With personal saving rates double those of the United States, and corporations that are often flush with cash, the potential for attracting deposits is tremendous. On the other hand, competition is painfully intense and the expression "bigger is better" carries great weight among bankers. Furthermore, government regulation of the financial system was very strict until recently, limiting the flexiblity of financial institutions under changing market conditions. Finally, lucrative markets that are the bread and butter of banks in Western industrialized nations are very weak in Japan.

Foreign banks have found it difficult to take root and prosper in this severe environment, but the same could be said of their Japanese counterparts. Although Tokyo's financial liberalization program brings the promise of rain after the long drought, foreign banks in Japan find themselves at a crossroads. This report will look at problems they have encountered and explore future opportunities.

The Banking Market

Japanese banks played a well-documented role in the economy's rapid postwar recovery, providing the financial lubrication and fuel to keep industry humming. But as the economy moves into the post-industrial stage, its financial needs are changing. While banks will retain a central role in economic activity, the industry is on the brink of a major restructuring effort.

Japan's banking system, like its legal code and political machinery, was modeled after existing Western ones but adapted to Japanese needs. The National Bank Act of 1872 borrowed heavily from U.S. legislation to create a national banking system. Americans had an even greater impact on Japan's financial system during the occupation immediately following World War II when revisions in the Banking Law of 1927 set the mold for Japanese banks through the start of this decade. The most significant modification was the adoption of provisions similar to the National Banking Act of 1933 (Glass-Steagall Act) that erected barriers between commercial banking and securities dealing.

Prior to this change, banks almost completely dominated Japanese financial life and securities companies were banished to the fringe of financial markets. On the strength of their position at the center of the large, prewar industrial groups (zaibatsu), banks not only accepted deposits and issued loans, but also underwrote bond and equity issues. This dominance ended during the American occupation when banks were restricted to accepting deposits and making loans. Purchases and sales of securities were prohibited except in the following situations: on behalf of and at the express order of customers with accounts; for a bank's own investment purposes; or as required to implement a trust agreement.

Ministry of Finance administrative regulations and subsequent legislation completed the web of controls that so firmly bound Japanese banks to monetary policy and insulated them from international forces. In addition to the normal controls on reserves, deposits and lending operations, the government regulated interest rates and loan maturities as well as foreign exchange and interbank transactions. Even the number of branches and hours of operation were tightly regulated. Absent market forces, broad consumer credit markets did not develop beyond a rudimentary stage as governemnt policy encouraged corporate borrowing and individual saving. In short, Japanese banks focused their efforts on a just a few areas of activity and tended to specialize in serving some particular type of customer. The effects of specialization did not restrain their expansion, however, which is in part a reflection of the remarkable growth of the economy.

There are several different types of banks in Japan, although the distinctions have faded with time and changing regulations. Commercial banks (and just recently trust banks) count among their ranks the foreign members of Japan's banking community. Foreign banks actually opened their doors in Japan ahead of domestic institutions, but this has not translated into a strong foreign presence in the market, mainly due to the formidable competition.

In the commercial bank category, there are 12 so-called city banks, which are based primarily in urban centers but have a nationwide network of offices, and 65 regional banks, which operate primarily in rural areas. The city banks (plus the Bank of Tokyo, which was once solely a foreign-exchange bank) all rank among the world's leading commercial banks in terms of assets and profits. These institutions dominate the market for large corporate customers, while the regional banks serve the needs of small businessmen and

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consumers. Trust banks, mutual savings and loan (sogo) banks and government-operated savings institutions, such as the Postal Savings System, account for the remainder of deposits.

Out of Step with Current Conditions

Until the last 10 years, banks in Japan enjoyed a relatively simple business environment. Domestic corporations relied very heavily on bank borrowing to finance investment, government borrowing needs were modest, and the Ministry of Finance buffered the impact of international financial shocks. Thanks to rapid economic growth, loans and deposits increased with a minimum of effort. The two oil shocks of the 1970s, however, fundamentally altered this tranquil picture. Economic growth rates fell precipitously, forcing companies to scale back their borrowing plans and pushing the government into deficit spending.

This proved a devastating combination to Japanese bankers as low-paying government bonds replaced profitable corporate loans. In addition, the lean times intensified competition between banks and eroded the strength of loan portfolios as the bankruptcy rate soared. Financial institutions began to search for ways around the barriers between banking and securities operations, leading to a blurring of regulatory distinctions. By 1975 the government realized that the banking system would be unable to handle the burden of financing current deficits and refinancing past debt while at the same time helping industry cope with international competition.

These deficiencies were examined for four years by a government-appointed advisory panel that in 1979 advocated major structural modifications to the banking system. Based on these recommendations along with another report on bond and equity markets, the Ministry of Finance drew up new banking regulations that were approved by the Diet on May 25, 1981. The Banking Law of 1981 codified many MOF's administrative practices developed over the years and conferred new regulatory powers on the already powerful bureaucracy. At the same time, however, it opened the door for radical changes in the financial system by allowing Japanese commercial banks to handle the primary and secondary sales of government bonds and widening the scope of banking-related activities. In addition, it clarified the obligations and rights of foreign banks; most significantly, the Ministry of Finance granted them national treatment.

Since the new law went into effect in April 1982, financial reform has gained considerable momentum (see JEI Report No. 8A, February 28, 1986), in part thanks to an agreement with the United States on several aspects of liberalization, including securities trading, trust banking and the Euroyen market (see JEI Report No. 22B, June 8, 1984). Commercial banks gained more room to maneuver and are permitted to offer new instruments, but they also face new competition from other domestic and foreign financial institutions. At the same time, consumer and corporate expectations have increased, demanding greater sophistication from all financial institutions.

The Foreign Bank Experience

The liberalization movement has probably been hardest on foreign commercial banks operating in Japan. On the one hand, they have lost whatever unique services they could offer Japanese companies. But on the other, they now have an opportunity to parlay their links with foreign parents and their experience in consumer and corporate finance into a stronger position.

Under the heavy guidance of MOF and the Bank of Japan, foreign banks have not enjoyed significant growth in Japan. Even after a decade of 10 percent-plus annual economic growth, there were only 18 foreign banks operating in Japan in 1970. Today, their number has grown to 78, including both firms with representative offices as well as those with branches. Nevertheless, the impact of controls is still clear. These 78 foreign banks have a total of 113 offices, far below the average for Japanese city banks (200) and regional banks (85). This limited presence has severely restricted their ability to attract deposits and make loans. They account for an average of 1 to 2 percent of all bank deposits and their share of outstanding loans has fluctuated between 2 percent and 3.5 percent since 1950 (see Tables 1-4 for comparison). MOF-imposed foreign-exchange swap limits restricted the amount of assets they could receive from the parent bank, forcing foreign banks into short-term interbank markets to raise funds. Obviously this not only limited the amounts a bank could raise but also greatly increased the cost of funds.

Foreign banks have had great difficulty attracting Japanese customers and have contented themselves with making yen loans to subsidiaries of foreign companies, or foreign currency loans (so-called "impact loans") to Japanese firms. Because foreign direct investment was only completely liberalized in the mid-1970s and MOF began allowing domestic banks to make impact loans in the late 1970s, foreign banks have not been overwhelmed with customers. According to MOF data, the growth of lending by foreign banks slowed from 30 to 50 percent in the 1960-75 period to 10 percent annually through 1983 and then to zero in fiscal 1984. Impact loans in particular contracted, from a high of $2.3 billion in fiscal 1982 to $939 million in fiscal 1984. Even more discouraging, the foreign bank share of impact loans fell from 60 percent to 18.6 percent over the same period. Efforts by non-Japanese banks to move into areas of consumer finance, leasing and investment banking have been stymied by the morass of financial regulations. As can be seen in Table 5, earnings have suffered over the past several years. Although to date foreign banks have not played a significant role in Japan's banking market, financial liberalization may change this situation.

Perils and Opportunities in the New Environment

The new regulatory environment promises to realign and restructure Japan's entire financial system. Even the modest amount of deregulation already implemented has affected the earnings of financial institutions. According to a February 1986 Nihon Keizai Shimbun profit survey, securities companies and trust banks have moved up rapidly while medium- and small-sized city and regional banks have drifted downward. Several trends that will determine the fate of all banks in Japan are becoming evident:

- Mergers - The announced merger between Sumitomo Bank, Ltd., the third-largest city bank in terms of assets, and Heiwa Sogo Bank, Ltd., the sixth-ranked mutual savings and loan bank, ended a crisis surrounding the troubled *sogo* bank and is the beginning of a shakeout in the banking industry. Although this is not the largest merger between banks (Dai-Ichi Bank, Ltd. and

Nippon Kangyo Bank, Ltd. combined in 1971 to create Dai-Ichi Kangyo Bank, Ltd., still the nation's largest), it is significant in several respects. The move is considered an aggressive one given the financial distress of Heiwa Sogo. Sumitomo is convinced that Heiwa's large number of Tokyo offices, impressive pool of individual depositors and extended banking hours will prove well worth their cost. Second, MOF apparently decided to make an example of Heiwa Sogo to warn other banks that deregulation implies the freedom to fail as well as succeed. Authorities refused to step in at an early stage when it was clear that Heiwa was experiencing business problems and management strife. Nor was the usual tactic of arranging a rescue by several banks attempted. Finally, Citibank was interested in a takeover but backed away because of the *sogo* bank's complicated financial problems, not MOF disapproval.

The world's largest bank is not discouraged, however, and is still said to be shopping for a Japanese bank. This market is becoming crowded with buyers and sellers alike. Sumitomo's competitors are looking over the prospects and many regional banks are holding discussions aimed at banding together to compete with larger rivals. *Toyo Keizai Weekly* feels that if the economy slows drastically, as many as 9 city banks, 34 regional banks and 54 *sogo* banks will encounter problems and become possible merger targets. The opportunities for foreign banks are obvious.

- *Trust banking* - With an estimated Y50 trillion ($277.8 billion at Y180=$1.00) in government pension trusts and as much as three times that in private trusts, the lure of trust banking is overpowering. In the past six months, six American banks have received MOF permission to operate trust banks in Japan: Morgan Guaranty Trust Co., Bankers Trust Co., Chemical Bank, Chase Manhattan Bank, Citibank and most recently Manufacturers Hanover Trust Co. Although some issues remain, it is expected that more banks from the United States and Europe will follow as Japan's society ages and pension funds balloon.

- *Commercial paper* - This is a major innovation under the 1981 Banking Law. Although banks have been lobbying MOF against the creation of such a market since it would reduce corporate reliance on bank lending even further, its inception is clearly on the horizon. Given their expertise at handling the fast-moving U.S. market for corporate credit, American banks may stake out a strong position in any future Japanese market.

- *Bond futures* - After a rocky start in October 1985, the bond futures market has settled down and is showing good potential. Since interest rates have fallen and investors are becoming better acquainted with the market, trading should expand quickly. This is another market that is old hat to U.S. banks and may therefore offer another avenue of expansion.

- *Consumer finance* - This market will undoubtedly take many years to develop into a profitable business. Nevertheless, the field has been receiving fresh attention from domestic and foreign banks alike. Citibank is interested in buying a small Japanese bank primarily to offer expanded consumer financing services. Other Japanese banks see a trend toward more leisure and luxury and are eager to fulfill those desires. Regulatory barriers remain, however, and MOF has been reluctant to discuss the issue. Furthermore, institutional weaknesses severely hamper consumer financing efforts. The absence of independent consumer credit rating organizations is a real problem. If the credit infrastructure can be brought to an acceptable level, however, the abundant pool of personal savings could mean a lucrative consumer finance market.

- Electronic services - Japan has staked its future on electronics and integrated communications. It is no surprise, therefore, that Japanese banks are interested in capitalizing on this trend. Automatic teller machines are presently installed only at branch offices and operate exclusively during regular business hours. The banks' game plan seems to be to get the hours of operation extended and then hope for permission to put the ATMs in stores and shopping areas. Ultimately, the banks hope to link their equipment with the point-of-sale systems now being installed by retailers to create a debit card system (see JEI Report No. 44B, November 15, 1985). Value-added network systems are another area that banks hope to penetrate. Offering on-line banking, investment and cash management services holds the promise of lower operating costs for banks and more efficient use of funds for corporations. For U.S. banks, which have employed such systems for several years, these improvements offer the potential to acquire an increased share of these markets.

- International services - MOF's yen internationalization program has created a booming market for international banking services. Although Japanese firms are moving aggressively abroad to meet these needs, American and European banks are well-entrenched and eager to go toe-to-toe with the Japanese. By expanding into Japan, moreover, some foreign firms may be able to further strengthen their hand. Both trends will hasten the advent of 24-hour banking.

Outlook

The Japanese banking market is clearly in ferment and MOF is only likely to turn up the heat. Just recently the ministry hinted that it was considering weakening the remaining distinctions between commercial and investment banking. As interest rates are slowly deregulated and controls on trust managers and corporate comptrollers are eliminated, banks will have to supply increasingly sophisticated services to stay competitive.

MOF hopes to prepare Japanese banks for full integration into the international financial system by establishing an offshore banking facility in Tokyo. Legislation enabling this artificial haven from domestic financial regulations will be submitted to the current Diet for implementation as early as October. Foreign banks would find this arrangement much more favorable since Japanese corporations are expected to flock to the market and it would operate as the offshore facilities in New York and London now do.

If MOF continues on its course of blurring barriers, banks will hasten to participate in 24-hour bond and securities trading as it develops. With Japan's savings rate unlikely to fall significantly and controls on international capital flows easing, Japan almost surely will assume the position of top creditor nation -- if it has not already done so. Although the economic implications are unclear, it will definitely result in fat profits for domestic and foreign banks and securities firms.

However, there are some clouds in the sky. Japan is becoming increasingly embroiled in bilateral negotiations over financial reciprocity with its major trading partners, most notably the United States and Great Britain. If these negotiations are not successfully resolved, foreign and Japanese banks may find themselves barred from each other's markets to the detriment of all concerned.

For many reasons, foreign banks are at a crossroads in Japan. After years of poor results, should they hold on, hoping that MOF's liberalization plans will offer fresh growth opportunities; or withdraw and wait for the Japanese to come to them? While some have answered with the latter, most seem to be taking the optimistic view and are persisting in their efforts to meet the financial needs of the world's second-largest economy.

For further information, contact Jon Choy.

* * * * * *

The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Principal Accounts of Foreign Banks in Japan, 1981-85

(figures for December of each year in billions of yen)

	1981	1982	1983	1984	1985
Assets					
Cash and Deposits	Y3,236.9	Y3,520.4	Y3,718.3	Y3,353.5	Y2,024.2
Call Loans	868.4	993.5	1,029.8	1,509.2	1,663.3
Bills Bought	69.7	178.5	389.4	224.6	1,416.1
Securities	351.7	255.4	323.9	390.7	515.8
Loans	5,292.8	5,892.3	6,617.7	6,848.8	4,888.3
Total	9,819.5	10,840.1	12,079.1	12,326.8	10,507.7
Liabilities					
Deposits	Y1,389.5	Y1,500.1	Y1,591.0	Y1,898.9	Y1,711.6
Certificates of Deposit	413.7	362.9	429.3	404.9	754.0
Call Money	1,789.5	2,278.2	2,971.4	2,717.5	2,086.8
Bills Sold	873.4	530.5	889.3	504.8	263.5
Borrowed Money	740.1	826.9	976.5	1,129.3	1,352.3
Total	5,206.2	5,498.6	6,857.5	6,655.4	6,168.2

Table 2: Accounts of All Banks in Japan, 1981-85

(figures for December of each year in billions of yen)

	1981	1982	1983	1984	1985
Assets					
Cash and Deposits	Y17,087.9	Y18,267.8	Y21,271.8	Y24,029.4	Y25,884.0
Call Loans	5,758.1	8,147.4	10,404.6	9,526.4	13,076.9
Bills Bought	416.2	582.9	309.9	429.6	1,256.6
Securities	43,205.0	45,605.5	49,141.0	52,557.9	57,790.4
Loans	151,213.7	167,677.5	186,346.3	210,479.0	237,170.0
Foreign Exchange	6,307.6	5,835.4	5,514.6	5,887.4	6,436.8
Acceptances	16,824.7	17,331.9	17,096.6	17,853.2	20,426.2
Total	249,887.2	272,412.6	299,507.5	332,354.7	376,236.7
Liabilities and Net Worth					
Deposits	Y168,744.5	Y179,995.7	Y194,895.5	Y211,031.3	Y230,601.9
Certificates of Deposit	2,674.0	3,581.1	4,612.4	7,210.7	7,979.6
Bank Debentures	21,182.5	23,337.6	26,265.1	29,379.4	31,454.2
Call Money	7,464.9	9,195.6	10,805.0	12,305.3	15,704.1
Bills Sold	2,743.4	4,888.5	5,859.1	7,372.5	14,199.6
Borrowed Money	1,563.9	2,119.1	3,712.2	3,015.0	4,186.6
Foreign Exchange	1,976.5	2,156.0	1,572.1	1,246.3	1,187.8
Guarantees	16,824.7	17,331.9	17,096.6	17,853.2	20,426.2
Capital	2,050.0	2,095.7	2,165.7	2,240.2	2,426.6
Profit/Loss	3,988.7	4,067.8	5,479.6	6,086.2	6,063.1
Total	249,887.2	272,412.6	299,507.5	332,354.7	376,236.7

Table 3: Accounts of City Banks, 1981-85

(figures for December of each year in billions of yen)

	1981	1982	1983	1984	1985
Assets					
Cash and Deposits	Y10,677.3	Y11,262.7	Y13,240.4	Y14,750.8	Y15,483.3
Call Loans	3,584.3	4,851.4	6,191.5	5,002.5	7,279.1
Bills Bought	--	--	--	--	394.0
Securities	17,363.6	17,738.2	19,168.1	20,134.8	22,101.7
Loans	78,801.2	87,094.9	96,438.9	108,128.1	123,471.2
Foreign Exchange	4,939.4	4,714.7	4,550.9	4,813.1	5,114.2
Acceptances	10,881.1	11,398.6	11,188.8	11,447.8	13,179.4
Total	131,242.6	141,903.2	155,707.1	170,185.8	193,970.2
Liabilities and Net Worth					
Deposits	93,972.5	99,022.2	107,890.0	114,814.8	125,619.5
Certificates of Deposit	1,855.6	2,085.4	2,750.2	4,595.6	4,890.5
Bank Debentures	1,565.8	1,825.7	2,095.5	2,285.7	2,599.0
Call Money	5,942.2	6,771.8	7,071.8	7,997.6	6,834.5
Bills Sold	2,709.8	4,834.6	5,787.6	7,160.5	12,590.0
Borrowed Money	1,313.8	1,929.4	3,370.5	2,692.0	3,543.5
Foreign Exchange	1,366.7	1,626.6	1,155.4	958.0	1,033.0
Guarantees	10,881.1	11,398.6	11,188.8	11,447.8	13,179.4
Capital	1,027.0	1,048.0	1,062.0	1,079.7	1,209.1
Profit/Loss	1,424.6	1,337.1	1,905.6	1,970.0	1,794.5
Total	131,242.6	141,903.2	155,707.1	170,185.8	193,970.2

Table 4: Accounts of Regional Banks, 1981-85

(figures for December of each year in billions of yen)

	1981	1982	1983	1984	1985
Assets					
Cash and Deposits	Y4,082.6	Y4,380.3	Y4,855.6	Y5,574.9	Y5,729.0
Call Loans	1,405.7	2,021.5	2,583.6	2,867.2	3,930.6
Bills Bought	272.5	184.3	67.9	133.6	483.4
Securities	15,911.8	16,706.1	17,485.3	18,314.9	19,405.8
Loans	48,448.8	53,143.5	58,394.2	65,430.6	70,853.5
Foreign Exchange	322.7	321.4	345.2	403.2	457.3
Acceptances	2,735.8	2,559.5	2,425.6	2,575.7	2,656.3
Total	75,758.3	81,999.8	89,005.1	99,020.9	107,892.6
Liabilities and Net Worth					
Deposits	Y65,028.6	Y70,537.2	Y75,801.1	Y83,731.4	Y90,733.3
Certificates of Deposit	420.4	744.7	1,145.8	1,760.5	1,763.0
Bank Debentures	--	--	--	--	--
Call Money	435.0	588.8	1,030.4	987.7	2,106.1
Bills Sold	30.5	53.9	55.0	212.0	517.1
Borrowed Money	213.3	236.2	313.8	289.9	326.6
Foreign Exchange	104.9	102.6	105.4	77.1	49.1
Guarantees	2,735.8	2,559.5	2,425.6	2,575.7	2,656.3
Capital	559.0	583.6	602.0	648.2	688.5
Profit/Loss	1,828.3	1,972.3	2,664.6	2,983.0	2,908.0
Total	75,758.3	81,999.8	89,005.1	99,020.9	107,892.6

Table 5: Top Japanese and Foreign Banks in Japan, FY 1983-84

(place among all private commercial banks and net income in millions of yen)

	FY 1983		FY 1984	
	Rank	Net Income	Rank	Net Income
Sumitomo Bank, Ltd.	1	Y199,828	1	Y157,096
Fuji Bank, Ltd.	2	165,552	3	152,064
Sanwa Bank, Ltd.	3	131,267	2	152,782
Mitsubishi Bank, Ltd.	4	117,324	4	136,242
Dai-Ichi Kangyo Bank, Ltd.	5	99,338	5	133,532
Mitsui Bank, Ltd.	6	86,394	9	82,023
Tokai Bank, Ltd.	7	70,038	8	82,158
Bank of Tokyo, Ltd.	8	61,077	7	109,708
Taiyo Kobe Bank, Ltd.	9	58,931	11	60,228
Nippon Credit Bank, Ltd.	10	40,867	12	51,463
Citibank	94	2,384	86	3,652
Deutsches Bank	96	1,728	101	1,309
Morgan Guaranty Trust Co.	99	1,108	99	1,464
Manufacturers Hanover Trust Co.	101	938	--	n.a.
Chemical Bank	102	960	94	2,362
Bank Indosuez	104	853	--	n.a.
Lloyds' Bank International, Ltd.	105	712	118	295
Bangkok Bank, Ltd.	106	695	126	171
Bank of India, Ltd.	109	492	109	501
Indostate Bank, Ltd.	110	444	110	474
Wells Fargo Bank	111	436	114	319
American Express International	112	414	119	293
Bank of America	--	n.a.	98	1,516
Bankers Trust Co.	--	n.a.	104	839
Irving Trust Co.	--	n.a.	107	700

Source: Toyo Keizai Shukan, May 19, 1984 and September 7, 1985.

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REPORT

NO. 11B
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Lower House Passes Austere FY 1986 Budget

On March 8 Japan's House of Representatives passed a Y54.1 trillion ($300.5 billion at Y180=$1.00) budget for FY 1986 (April 1, 1986-March 31, 1987). Although the bill, supported by the Liberal Democratic Party-New Liberal Club coalition, was sent to the House of Councillors for debate, the budget will take effect April 7 even without upper house approval.

The budget passed by the lower house is virtually identical to the one ratified by the cabinet last December (see JEI Report No. 1B, January 10, 1986). Total spending is set to rise 3 percent in nominal terms, somewhat less than the 3.7 percent increase in FY 1985's initial budget. The increase is primarily due to a 5.1 percent rise in transfers to local governments and a

10.7 percent increase in debt service costs (see Table). Interest payments on Japan's national debt as a share of government expenditures will exceed 20 percent for the first time. This compares to a 14.4 percent share in the United States in FY 1985 (October 1984-September 1985).

Highlights of Japan's Proposed FY 1986 Budget

(initial budgets in billions of yen)

	FY 1985	FY 1986	Change
Total General Budget Expenditures	Y52,499.6	Y54,088.6	3.0%
Discretionary Expenditures	32,585.4	32,584.2	-0.0
Fiscal Investment and Loan Program	20,858.0	22,155.1	6.2
National Bond Issues	11,680.0	10,946.0	-6.3
Deficit Bonds	5,730.0	5,246.0	-8.4
Construction Bonds	5,950.0	5,700.0	-4.4
Refinancing Bonds	8,960.0	11,492.4	28.3
General Account Expenditures			
Interest on Government Debt	10,224.2	11,319.5	10.7
Transfers to Local Governments	9,690.1	10,185.0	5.1
Social Welfare	9,576.6	9,834.6	2.7
Public Works	6,368.9	6,223.3	-2.3
Education, Science and Technology	4,840.9	4,844.5	0.1
Defense	3,137.1	3,343.5	6.6
Energy Measures	628.8	629.7	0.1
Official Development Assistance	581.0	621.7	7.0
Small and Medium Businesses	216.2	205.2	-5.1

As part of Prime Minister Yasuhiro Nakasone's program to end reliance on deficit-financing bonds by FY 1990, discretionary expenditures will be reduced for the fourth consecutive year. Spending on public works, a major source of pump priming, will be cut 2.3 percent, while defense and foreign aid are set to increase 6.6 percent and 7 percent, respectively. The Fiscal Investment and Loan Program, which is funded primarily by the postal savings system, is slated to increase 6.2 percent after declining in FY 1985.

On the revenue side, changes in the tax system are expected to bring in an additional Y341 billion ($1.9 billion). Much of the burden will fall on the business sector, as the carryover of losses from the previous year will be disallowed temporarily and the 1.3 percent corporate income tax surcharge will be continued. Furthermore, there will be a hike in the excise tax on tobacco products. These increased revenues will be partially offset by tax credits designed to stimulate home purchases. The Finance Ministry plans to issue a total of Y22.4 trillion ($124.6 billion) worth of bonds in FY 1986, with slightly over one-half intended to refinance outstanding debt.

Although fiscal policy should have a mild stimulative impact on the economy in FY 1986 in contrast to the year through March 1986, many observers fear that continued fiscal austerity in the face of the strong yen will slow growth and tax revenues, making it impossible to meet the twin goals of fiscal stability and expanding domestic demand. On the plus side, though, the decline in oil prices and interest rates should give a significant boost to the private sector.

Randall S. Jones

Rising Yen Reduces Corporate Profits

Japanese corporate profits for fiscal 1985 (ending March 31, 1986) will decline for the first time in three years, according to surveys of major firms by private research organizations. The decline is largely a result of the 43 percent appreciation of the yen since the beginning of the current fiscal year, which has reduced the earnings of many major exporters.

The downturn began during the last quarter of 1985, according to a Finance Ministry survey, when corporate profits declined for the first time since 1983's first quarter. The overall 2.2 percent drop from year-earlier levels was concentrated in major export industries, such as steel, where profits fell 74.8 percent. In contrast, the electric power industry, which benefited from lower oil prices, saw profits rise 35.4 percent.

Corporate profits during FY 1985 will decline between 9.2 percent and 10.8 percent, led by a 21 to 25 percent fall in the manufacturing sector, according to surveys by private research institutes. Particularly notable is the expected 30 percent decline in electric machinery, which includes semiconductors. Profits in the nonmanufacturing sector, however, including oil refining and electric power industries, are expected to increase some 9 to 16 percent.

The reluctance of Japanese firms to raise the dollar prices of their exports by the full amount of the yen's appreciation against the dollar has lowered the yen value of exports and reduced earnings. In the last three months of calendar 1985, the yen value of Japan's exports was down 5.2 percent from 1984's fourth quarter total. During the 1978 rise in the yen, in contrast, rapid growth and high inflation in the United States and other industrialized countries enabled Japanese exporters to raise prices by the full amount of the yen's appreciation without sacrificing export volume. With lower rates of inflation and increased competition from other countries, particularly Korea, Japanese firms are now more hesitant to raise prices.

As for profits in FY 1986, the surveys give sharply different results. Waco Research Institute of Economics Inc., for example, reports that profits are expected to decline 6.4 percent, while Nihon Keizai Shimbun expects an 8.3 percent rise. An increase beginning in the second half of FY 1986 appears more plausible for several reasons. The one percentage point fall in interest rates during the past two months and the decline in oil prices will stimulate the economy. The Institute of Energy Economics estimates that the cost of Japan's oil imports will fall almost 50 percent during FY 1986. Furthermore, the cost-cutting measures adopted by Japanese firms in response to the high yen should help restore profit margins.

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Japan's Economy Surges Ahead In Fourth Quarter

Continued strong growth in business investment and a recovery in residential construction led to a sharp expansion in Japan's economy in the October-December period. The increase in gross national product at an inflation-adjusted annual rate of 7.2 percent, compared to 3 percent in the preceding three months (see Table), surprised many economists. Calendar year 1985 growth registered 4.6 percent, a modest slowdown from 1984's 5.1 percent rate.

Private investment increased at double-digit rates for the third consecutive quarter, led by the nonmanufacturing sector. Plant and equipment outlays by manufacturers slowed, though, reflecting the downward trend in export shipments. Measures to increase home purchases in last October's demand stimulation package (see JEI Report No. 40B, October 18, 1985) encouraged the 9.1 percent rise in residential construction, as housing starts increased each month during 1985's final quarter.

The economy's impressive growth occurred despite the second consecutive quarterly drop in exports. The decline reflected the fall in the yen value of shipments to the United States and China. The external sector, however, made a net positive contribution to growth of about 1 percentage point, as the fall in imports exceeded that of exports.

Personal consumption continued to increase at a sluggish pace, rising just 2.2 percent, because of modest income gains. The increase in income was only 2.8 percent in real terms compared to year-earlier levels. During the past seven quarters, the rise in consumer spending has exceeded 2.2 percent only once.

It is not anticipated that growth in the coming months will match the impressive fourth-quarter results. Most exports for the October-December period were contracted prior to the sharp appreciation of the yen that began in late September. Bigger declines in shipments are expected as the export volume responds to the higher yen. Industrial production was down 3 percent in the last three months of 1985, and the Economic Planning Agency predicts another 0.2 percent fall in the January-March quarter. This would mark the first time production has fallen three consecutive quarters since the 1973 oil crisis. The government plans to announce a package of measures to stimulate domestic demand prior to Prime Minister Yasuhiro Nakasone's departure for Washington on April 12.

The pace of personal consumption expenditures, which accounts for over one-half of GNP, will play a major role in determining whether the current expansion continues. In the six months following the 1978 appreciation of the yen, consumption increased at an inflation-adjusted annual rate of 7.5 percent. Despite a slight drop in the growth of nominal income from fiscal 1977 to fiscal 1978, the fall in the inflation rate from 6.8 percent to 3.4 percent boosted real income and consumer spending.

It is unclear, though, whether the recent appreciation of the yen will lead to an equally sharp dip in the inflation rate. In December the government predicted that the rise in the consumer price index would fall from an already low 2.1 percent in FY 1985 to 1.9 percent in FY 1986. Furthermore, the prospects for wage increases are uncertain. While the unions are pushing for at least a 7 percent hike during the annual spring wage bargaining, the chairman of the Japan Federation of Employers' Associations, Bunpei Ohtsuki, has argued for a 3 percent rise. Forecasters such as Nihon Keizai Shimbun and Nomura Research Institute expect a 4.5 to 4.8 percent increase, which would be less than last year's 5 percent rise.

This year, though, the government has clearly indicated its support for a large wage increase to stimulate domestic demand. The prime minister's Industrial Structure Council recently noted that "both nominal and real wage increases in 1983 and 1984 trailed the rise in productivity," and called for a larger share of national income for wages.

Randall S. Jones

Australia increased steadily as the market for primary commodities, particularly wool, expanded rapidly. But bitter memories lingered in Australia, as may be seen in accounts of the multilateral negotiations leading up to the peace treaty of 1951. Moreover, Canberra maintained strong protection of the domestic manufacturing sector. These factors restricted Japan's share of Australia's overseas purchases to only 2 to 3 percent -- mostly in textile products.

Japan obtained full membership in the General Agreement on Tariffs and Trade in 1955 and continued its campaign for a bilateral trade agreement and most-favored-nation privileges with Australia. In 1957, with much trepidation, government officials in Canberra gave in to pressure and signed an "Agreement on Commerce" with Tokyo. However, the document contained a provision allowing Australia to act unilaterally against Japanese imports thought to be damaging to domestic industry. Australia also withheld MFN status from Japan. Even with these so-called "orderly marketing" aspects, however, the agreement created a storm of protest among Australian manufacturers and greatly disappointed the Japanese.

But the degree of economic complementarity between the two was beginning to be appreciated in Australia, and eventually won out over protectionism. When the 1957 agreement was renegotiated in 1963, the controversial unilateral retaliation provision was dropped and MFN rights were granted to Japan. The volume of goods exchanged was increasing rapidly and the pattern of trade was clearly beginning to change. Australia's textile fiber exports began the start of their slow decline and mineral exports noticeably picked up the slack -- with increased coal and copper ore shipments leading this trend. A decision to lift the embargo on iron ore exports at the start of the decade also boosted mineral exports substantially. Australia's imports from Japan continued to be dominated by textile products, but machinery and motor vehicle sales expanded discernibly -- the beginning of what would become Japan's most significant export category in the next few years.

At the same time, Japan's burgeoning heavy industrial sector consumed large quantities of Australian coal and iron ore. Manufacturing concerns bought more Australian copper ore, bauxite and nonferrous metals. Purchases of beef and food and feed grains also increased enormously. These developments were highlighted when Japan surpassed Great Britain as Australia's largest export market in 1967.

This great expansion in trade was not free from demands for protection from both sides. Japan's beef quotas and Australia's foreign motor vehicle restrictions were prominent examples. However, trade continued to grow throughout the 1970s, notwithstanding the first oil crisis and a deep recession in Australia. Realignments in international economic markets and consequent domestic considerations, however, forced the two countries to begin to look more critically at the pattern of bilateral trade.

As a result of the energy crisis, Japan set about diversifying its sources for agricultural and industrial raw material inputs. Simultaneously, Japan's limited share of Australian manufactured exports and its import restrictions on agricultural goods were raising not a little criticism in Australia.

Tensions came to a head in the mid-1970s when Japan overbought its beef quota and, facing demands from the United States for increased market access, blocked purchases of Australian beef for over a year. Simultaneously, the world sugar market softened and Japan sought a readjustment of prearranged contracts. Both sides charged the other with being unreliable, and similar sentiments showed up in political and diplomatic intercourse. Recognizing the importance of cooperation, in 1976 leaders of the two countries moved to ease strained relations by signing what for Australia was an unprecedented treaty of friendship and cooperation. Nicknamed NARA (Nippon-Australia Relations Agreement), the accord was closely followed by additional agreements concerning fishing rights, science, technology and cultural relations.

Significant amounts of Japanese capital began to flow to Australia during the 1970s despite numerous barriers to foreign investment. Not surprisingly, the largest share of investment went to the mining sector. In this case as well, though, Australian foreign investment policy fluctuated in its degree of receptivity, leading analysts to term attempts by Japan to invest and Australian willingness to accept this investment "countercyclical."

Table 1: Japan's Trade with Australia, 1960-85

(in millions of dollars)

Year	Exports (f.o.b.)	Imports (c.i.f.)	Balance
1960	$144.1	$343.7	$-199.6
1965	313.3	552.1	-238.8
1970	589.0	1,507.7	-918.7
1975	1,739.0	4,156.1	-2,417.2
1980	3,388.9	6,981.6	-3,592.7
1981	4,779.2	7,419.3	-2,640.1
1982	4,580.6	6,961.2	-2,380.6
1983	4,280.0	6,641.5	-2,361.7
1984	5,184.3	7,296.4	-2,112.2
1985	5,379.0	7,452.2	-2,073.2

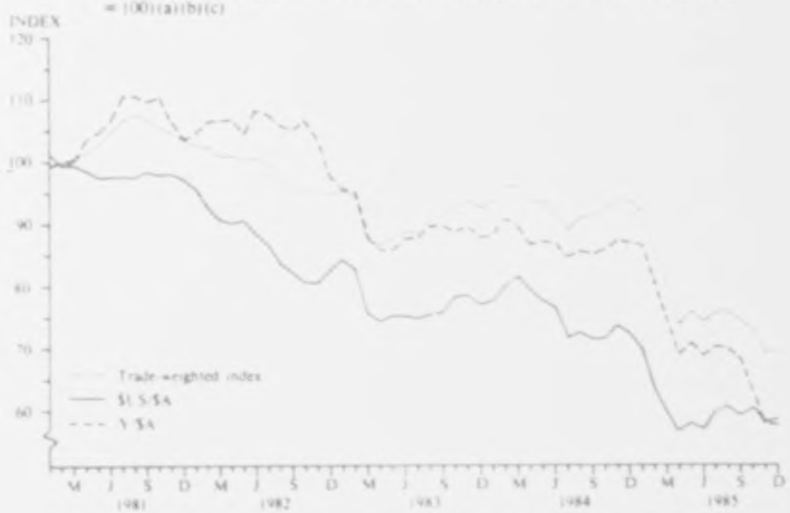
Source: Japan Tariff Association, The Summary Report: Trade of Japan

Recent Trends in Australia's Economy

In the last several years relations between Australia and Japan have been affected by significant domestic economic developments. (For Japanese coverage see JEI Reports No. 3A, January 24, 1986, and 8A, February 28, 1986). Developments in Australia, which not too ironically parallel those in Japan, include the commitment by Prime Minister Robert Hawke's Labor government to liberalize financial markets and ease trade barriers, and the refreshingly amiable pay accord worked out between the government and the usually militant labor unions. Australia's domestic economic recovery since the beginning of the decade has occurred at the same time that the Australian dollar has been allowed to float, interest rates have soared, contributing to an already well-marked tendency to import capital, and the nation's overall current account deficit has widened.

The current state of Australia's overall trade is important to note. During the first half of 1985 the country ran a trade surplus. But buoyant domestic demand unsatisfied by Australian-made goods boosted imports and reversed this condition in the second half of the year. Despite a prolonged plunge in the value of the Australian dollar against both the yen and the U.S. dollar, demand for imports has remained strong. Moreover, a depreciating currency has not aided Australian efforts to boost exports. The fall in international oil prices and weaker worldwide commodity prices have conspired to prevent the rise in shipments needed to trim the trade deficit. Australia runs a narrowing surplus with Japan, in part because orders from steel mills for iron ore and coal have lagged with the economic slowdown there and elsewhere in the world, compounding the difficulties.

MOVEMENTS OF THE AUSTRALIAN DOLLAR AGAINST SELECTED CURRENCIES AND IN THE TRADE-WEIGHTED INDEX (March Quarter 1981 = 100)(a)(b)(c)



(a) The TWI has been rebased to the March quarter 1981 = 100 and therefore differs from the figures shown in the table.
(b) Upward (downward) movements represent appreciation (depreciation) of the $A against other currencies.
(c) Monthly rates calculated as average of daily rates.

Source: Australia, Department of the Treasury, The Round-up, January 1986

The sustained drop in the value of the Australian dollar since February 1985 has renewed inflation and eroded confidence in the economy. The bad numbers have been a boon to the Hawke government's political opposition and a rallying cry for the hard-hit manufacturing sector. The Australian dollar has dropped to an unprecedented low of less than 70 cents to the U.S. dollar -- a psychological, if not actual, breach of Australian perceptions. (A more important indication comes from the currency's 25 percent drop in 1985 against a trade-weighted basket of currencies.) Last month Brian Powell of the

Australian Chamber of Commerce called on Australia to "wake up and wake up fast" to the trade deficit, inflation and the growing foreign debt. Observers have pointed out that Australia has fallen from being the eighth-largest exporter in the world to 23rd place.

Mr. Hawke and his finance department officials have thus been put in the position of defending their policy and tirelessly explaining the "J-curve effect." Australian Treasury representatives modestly estimate that the currency depreciation will eventually bring down the trade deficit from 4.9 percent of gross domestic product to 4.6 percent, with imports falling by 2 percent and exports rising by around 4.5 percent.

To actually get to this point, the Australian government is pinning its hopes on an improved performance by the manufacturing sector, increased trade in services and a rise in tourism. The carefully worked-out accord with labor was arranged for this purpose as well as to control inflationary pressures linked to wages that were previously adjusted every six months. The government hopes that enhanced confidence in the stability and reliability of Australian producers will stimulate exports of manufactured goods and spur employment opportunities. It also hopes to rekindle the interest of foreigners anxious to invest abroad. the Hawke government has made good on its promise to deregulate and internationalize the Australian banking system and loosen some foreign investment controls. This development is covered below.

Bilateral Trade

Japan's Imports from Australia - During the past five years Australia has continued to supply the raw materials needed by Japan. But the continuing shift of the Japanese economy from heavy manufacturing like steel to high technology industries has curbed demand. Furthermore, Japan's attempts to diversify resource suppliers and a slowing of economic growth have begun to substantially realign its previous trade patterns.

Japan's major imports from Australia include coal, iron ore, nonferrous metal scrap, aluminum, wool, cotton, beef, wheat, sugar and recently oil. Australia's share of total Japanese imports, which reached a peak of 9.4 percent in 1972, has declined to 5 percent-plus since 1980. In 1985 Australia ranked fifth as a supplier of goods to Japan (behind the United States, Saudi Arabia, Indonesia and the United Arab Emirates). Nonetheless, Australia's importance in Japanese markets is enhanced by the fact that it supplies half of all Japan's coal and iron ore as well as almost two-thirds of its beef and wool.

Due to Australia's key role as a supplier of industrial and agricultural inputs, Japan consistently runs a deficit in bilateral trade, although the flood of red ink has ebbed somewhat in recent years, in large part because purchases were no higher in 1985 than in 1980. This situation can be explained several ways. There are analysts who insist that Australia's price competitiveness has deteriorated, and that its suppliers seem to have difficulties meeting the demands of Japanese buyers. It is also noted that Japan has diversified its sources of supply for price, security and political reasons, and this has had an adverse impact on purchases from Australia. There are also those in Australia who claim, as do many in other countries, that Japan has raised barriers to imports that are very difficult to overcome.

All these suggestions have some merit, but the narrowing deficit can also be attributed to the drop in Australia's traditional raw material exports. Reduced requirements for coal, metal ores and textile fibers, which accounted for some 25 percent of Japan's overall imports in 1970, cut the share of these three categories to just 10 percent of the total in 1985. Consequently, Australia's penetration of Japanese markets has dropped overall, with dramatic declines in its share of Japan's food and fiber imports, and less marked but significant declines in ores.

In individual commodity terms, however, the trend seems less clear. Australia's share of Japanese markets for bauxite, beef and wool has indeed deteriorated, while sales of sugar have declined in volume along with those of other major suppliers. But its share of Japanese purchases of iron ore and wheat has held steady, and Australia as well as China and South Africa have increased their shares of the market for coal. It is perhaps most correct to conclude, at this point, that although several of Australia's traditional exports to Japan have suffered recently, some Australian goods have benefited from changes in the structure of Japan's economy.

Table 2: Japan's Imports from Australia, 1981-85

(in millions of dollars, c.i.f. value)

	1981	1982	1983	1984	1985
Total	$7,419.3	$6,961.2	$6,641.5	$7,296.4	$7,452.2
Food Products	1,396.8	1,164.2	1,031.4	1,209.0	1,119.8
Meat	405.6	390.6	389.0	364.1	343.1
Fish	174.2	172.5	162.1	159.7	181.0
Wheat	192.2	184.7	181.8	186.0	172.6
Sorghum	67.6	51.4	14.2	140.2	96.8
Sugar	267.4	114.9	104.2	81.6	61.0
Textile Materials	621.2	612.8	448.6	549.2	545.8
Wool	518.5	481.8	370.0	436.0	429.0
Cotton	100.0	126.3	75.2	109.4	114.0
Metal Ores and Scrap	1,817.5	1,905.7	1,741.5	1,815.8	1,693.6
Iron Ore	1,377.8	1,476.3	1,322.7	1,356.0	1,228.2
Nonferrous Metal Scrap	334.2	354.2	346.3	386.9	382.7
Metals	223.7	245.1	270.0	471.5	453.3
Nonferrous Metals	212.3	218.3	230.9	444.3	442.2
Mineral Fuels	2,674.9	2,516.5	2,648.0	2,690.8	2,960.1
Coal	2,287.9	2,164.5	2,223.2	2,332.9	2,254.6
Crude Oil	16.8	3.3	18.5	37.4	345.5
Other Agricultural and Industrial Inputs	166.8	160.0	160.3	180.3	174.4
Nonmetallic Mineral Ores	104.6	97.0	100.9	109.1	110.0
Chemicals	204.0	86.0	57.9	64.3	44.5
Machinery and Transport Equipment	14.5	17.3	28.2	37.5	59.2
Other	300.1	253.5	255.7	278.0	401.7

Source: Japan Tariff Association, The Summary Report: Trade of Japan

Nevertheless, due largely to past incidents, Australia is extremely sensitive to the overall drop in its penetration of Japanese import markets. Its apprehensions are centered on the implications of continuing Japanese market opening plans. Specifically, there is fear that concessions to the United States and Europe, particularly concerning agricultural products, will cost Australia market share. A highly politicized topic in this regard concerns beef exports. When Tokyo accommodated U.S. requests in April 1984 to up purchases of high-quality (grain fed) beef after years of difficult bilateral negotiations, Australian market opportunities were in effect cut. Japan later promised to raise aggregate beef imports from 135,000 metric tons in FY 1982 to 177,000 metric tons in FY 1987, but Canberra continues to seek assurances that it will not be forgotten among Japan's other trading problem priorities.

Japan's Exports to Australia - Japan's deliveries to Australia are hardly striking in terms of total Japanese exports; they have not exceeded 4 percent in the last thirty years. However, Japan is a very important supplier for Australia. After a temporary dip in market share during the late 1970s, Japan's exports to Australia began to expand and by FY 1983 (July 1983-June 1984) Japan had outstripped the United States as the largest supplier of Australian imports. During that year Japan was the source of 22 percent of Australia's total imports, and the trend shows no sign of slowing.

This state of affairs creates numerous political sensitivities. In a manner all too similar to the ongoing debate in the United States, Australians are asking themselves about structural change in their economy and its implications for manufacturing, especially new industries. Alarm is registered by the quickly eroding trade surplus as Japanese exports grow at a faster rate than its purchases from Australia. Many in Canberra realize all too well that the country is increasingly dependent on Japanese products, while the Japanese are anything but dependent on Australian export markets. Those with a more long-term perspective warn that Australia may end up locked into a dependent relationship arising from a reliance on Japanese-made high technology products.

Without discounting factors such as consumer tastes and spending patterns, an important reason for the degree of Japanese market penetration is price competitiveness. Australian labor costs and price performance have been steadily deteriorating relative to those of Japan since 1970, according to Australian government estimates.

Japan's most important export is motor vehicles. Despite restrictions designed to protect domestic automotive manufacturers, exports of motor vehicles from Japan have grown to represent one-fourth of that country's total shipments to Australia. This is particularly evident in the car market; Japanese vehicles account for two-thirds of all imported cars and around 15 percent of the total Australian market. These percentages will undoubtedly grow larger. In a significant policy turnaround consistent with liberalization goals, the Australian government has initiated a "Car Industry Plan" that will remove tariff and quota prohibitions on auto imports and restrictions on partially manufactured motor vehicles by 1992. This is a market opening move that Canberra hopes will pay off with more Japanese confidence in the Australian marketplace and enhanced investment.

Table 3: Japan's Exports to Australia, 1981-85

(in millions of dollars, f.o.b. value)

	1981	1982	1983	1984	1985
Total Exports	$4,779.2	$4,580.6	$4,280.0	$5,184.3	$5,379.0
Food Products	30.8	26.7	27.7	33.5	27.4
Textiles and Apparel	232.3	232.0	243.0	259.0	224.7
Synthetic Yarn	39.1	37.8	42.2	42.4	35.0
Cotton Fabrics	43.8	50.9	51.9	63.1	47.8
Synthetic Fabrics	66.8	78.2	88.0	84.3	76.1
Chemicals	253.5	198.7	198.1	221.6	214.0
Plastic Materials	74.5	56.9	58.9	76.9	71.8
Manufactured Nonmetallic Mineral Products	90.2	70.5	57.7	76.2	79.9
Metals and Metal Products	499.2	561.5	283.8	360.0	308.2
Steel	375.2	381.7	199.3	236.1	206.0
Metal Products	96.8	160.1	75.8	109.8	90.9
Machinery and Transport Equipment	3,255.9	3,132.7	3,107.1	3,815.8	4,107.5
Power Generating Machinery	117.3	118.8	103.4	108.1	118.4
Office Machinery	129.7	142.4	192.2	251.9	316.2
Metalworking Machinery	72.3	61.6	21.4	55.2	77.1
Electric Power Machinery	73.2	97.2	72.6	54.6	65.7
Television Sets	76.8	48.8	44.7	51.9	47.1
Radio Receivers	67.2	66.2	52.9	74.4	82.1
Motor Vehicles	1,008.2	1,020.7	1,000.9	1,295.1	1,362.7
Motorcycles	105.4	75.5	73.3	71.4	66.0
Ships	159.9	93.6	79.2	36.9	55.3
Scientific and Optical Equipment	135.0	108.2	113.5	140.8	164.2
Audio and Video Recorders	148.1	190.5	280.6	259.1	191.9
Other	417.3	358.3	362.6	418.3	417.2
Tires and Tubes	89.8	80.3	65.6	97.3	86.2

Source: Japan Tariff Association, The Summary Report: Trade of Japan

Japanese manufacturers of nonelectric and electric machinery, chemicals and scientific instruments have made major inroads in the Australian market; in fact, Japan's share of the electric machinery import category stands at about one-third. On the other hand, declining Japanese price competitiveness in industries such as steel has reduced its share of those Australian import markets.

It is also worth noting that Japanese firms are successfully competing for large infrastructure projects. These undertakings are often financed by a consortium of Australian and Japanese public and private sources. A notable example is the newly announced 1.5-mile undersea tunnel linking the port of

Sydney with a northern suburb, which will begin in 1987. Japanese construction firms are also heavily involved in hotel construction and other building projects -- a development that has not gone without notice and expressions of concern from some Australians.

Investment Flows

Although it is conceivable that Australian investors may someday play a role in Japanese financial markets, the extent of that involvement today is negligible. According to Australian data for the early 1980s, Japan amounted to only about 5 percent of Australia's equity investment abroad. As part of Tokyo's recent financial market liberalization moves, four major Australian banks have gained permission to start full retail banking operations in Japan. Australia has also recognized the new opportunities for borrowing, and the benefits of increased access to the Tokyo stock exchange. But these developments are still only in the realm of possibility.

Table 4: Japan's Direct Investments in Australia, FY 180-FY 1984

(in millions of dollars)

FY 1980	$431
FY 1981	348
FY 1982	370
FY 1983	166
FY 1984	105
Cumulative Investment March 31, 1985	3,153
Share of Total Japanese Direct Foreign Investment	4.4%

Source: Ministry of Finance

The opposite is true of activity in the other direction. Based on developments over the last three years, Japanese capital flows to Australia show a great potential for growth. In the July 1984-June 1985 period, Canberra's data indicate, Japan squeezed out the United States and the United Kingdom as Australia's largest source of direct and portfolio investment.

The overall increase in Japan's investment in Australia is due to three factors: the liberalization of Australian (and Japanese) capital markets; the global rise of Japanese capital outflows, which began in 1981; and the gradual rise in foreign borrowing by the Australian government and private corporations.

Another major feature of Japanese investment in Australia is the radical change in its composition. Ten years ago direct investment represented over 80 percent of the total. By the start of the mid-1980s, in contrast, almost two-thirds of total Japanese investment consisted of portfolio investment and institutional loans.

This shift obviously corresponds to the increased borrowing activity of the Australian government. In the 1960s and 1970s import-restrictive policies were designed not only to protect domestic industry but also to keep foreign debt low. As the Australian dollar came under pressure and the balance of payments suffered, this policy was reversed. Debt rather than equity became the rule in foreign capital transactions.

Foreign investment is the subject of some debate in Australian politics. In fact, although certain controls have been relaxed, Mr. Hawke's government has moved more cautiously in liberalizing foreign investment than many business interests would like. Recently, for example, the Australian government decided to retain the Foreign Investment Review Board, which monitors foreign equity investment, although it did ease some of the terms for review.

Some 43 percent of Japan's investment in Australia between 1951 and 1983 went into primary industries; in contrast, only around 20 percent of all foreign investment in Australia over this period was earmarked for this sector. A sectoral breakdown based on Australian estimates further reveals that Japanese investment in Australian manufacturing accounted for 25 percent of its total (as opposed to 33 percent for all foreign investors), while services absorbed 32 percent (47 percent overall).

Recent figures show a new orientation. Japanese investment in the finance, insurance, real estate and service sectors rose from around 12 percent of the annual total during the Australian FY 1978-FY 1980 period to about 57 percent annually during the FY 1981-FY 1983 period. In contrast, investment in manufacturing skidded from 48 percent of yearly equity investment to just 2 percent. At the same time, Japanese direct investors continue to channel a large -- and growing -- proportion of their investments into mining despite doubts about the stability and competitiveness of this sector of the Australian economy. The share of total Japanese investment going into mining averaged close to 60 percent in three of the four years between FY 1980 and FY 1983.

The concentration of Japanese direct investment in the mining industry is a natural outcome of Japan's reliance on stable foreign supplies of industrial raw materials. In the past year, however, the flow of money to the mining sector fell as relatively few new development projects were floated. Prospects are looking up a bit for this year, though, since the Australian government agreed in early March to allow a consortium in which the Japan National Oil Corp. has a 50 percent stake to engage in oil exploration off the north coast of Australia.

Japan's involvement in the Australian financial sector is clearly linked to the liberalization of financial markets and the deregulation of the banking industry in both countries. In February 1985 Australia invited 16 overseas banks to establish full banking operations. Three Japanese banks were included -- the Bank of Tokyo, Ltd., Mitsubishi Bank, Ltd. and the Industrial Bank of Japan, Ltd. Although some critics oppose Australia's decision, the government anticipates that foreign investment will increase the efficiency of the banking sector, facilitate two-way trade and allow Australia to establish itself abroad by negotiating reciprocal banking rights.

It is expected that within the next five years the 16 new banks will command 20 percent of Australia's banking business. This may be assumed to be mostly due to activities like investment banking and foreign exchange operations rather than to retail and wholesale services. The Japanese banks seem to be moving cautiously, but there is some indication of their interests. They reportedly plan to establish only 15 retail branches between them, compared with as many as 130 branches envisioned by the five new U.S. banks.

Conclusion

Despite ongoing feelings of anxiety on both sides, it seems clear that economic relations between Australia and Japan will continue to flourish, for the essential complementary nature of their two nations remains intact. This optimism is justified by the generally constructive tone of discussions about the relationship by policymakers and industry representatives.

Clearly some degree of tolerance and education has been engendered by past altercations. Australian policymakers often remind the public and themselves that the country's relationship with Japan is really only one side of Japan's larger triangular relationship with the rest of the developed world, and Australia can only demand a reasonable amount of attention. At the same time, there is close interest in the opportunities effected by Japan's market liberalization moves, and a determination to seek out ways to deepen the economic ties between the two countries. Japanese officials respond sensitively to Canberra's feeling of vulnerability and applaud efforts to liberalize the Australian economy that in so many ways parallel Tokyo's own.

Indeed, if there is any one observation to make about the state of relations between the two countries, it is that the tremendous pace of change has not upset affairs between them. Change has, in fact, brought more discussion and examination of the dynamics of the relationship and challenged policymakers in both countries to broaden the context of their thinking about economic planning.

For further information, contact Sheri Hoptman.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

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Japan's Economy Surges Ahead In Fourth Quarter

Continued strong growth in business investment and a recovery in residential construction led to a sharp expansion in Japan's economy in the October-December period. The increase in gross national product at an inflation-adjusted annual rate of 7.2 percent, compared to 3 percent in the preceding three months (see Table), surprised many economists. Calendar year 1985 growth registered 4.6 percent, a modest slowdown from 1984's 5.1 percent rate.

Private investment increased at double-digit rates for the third consecutive quarter, led by the nonmanufacturing sector. Plant and equipment

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outlays by manufacturers slowed, though, reflecting the downward trend in export shipments. Measures to increase home purchases in last October's demand stimulation package (see JEI Report No. 40B, October 18, 1985) encouraged the 9.1 percent rise in residential construction, as housing starts increased each month during 1985's final quarter.

The economy's impressive growth occurred despite the second consecutive quarterly drop in exports. The decline reflected the fall in the yen value of shipments to the United States and China. The external sector, however, made a net positive contribution to growth of about 1 percentage point, as the fall in imports exceeded that of exports.

Personal consumption continued to increase at a sluggish pace, rising just 2.2 percent, because of modest income gains. The increase in income was only 2.8 percent in real terms compared to year-earlier levels. During the past seven quarters, the rise in consumer spending has exceeded 2.2 percent only once.

It is not anticipated that growth in the coming months will match the impressive fourth-quarter results. Most exports for the October-December period were contracted prior to the sharp appreciation of the yen that began in late September. Bigger declines in shipments are expected as the export volume responds to the higher yen. Industrial production was down 3 percent in the last three months of 1985, and the Economic Planning Agency predicts another 0.2 percent fall in the January-March quarter. This would mark the first time production has fallen three consecutive quarters since the 1973 oil crisis. The government plans to announce a package of measures to stimulate domestic demand prior to Prime Minister Yasuhiro Nakasone's departure for Washington on April 12.

The pace of personal consumption expenditures, which accounts for over one-half of GNP, will play a major role in determining whether the current expansion continues. In the six months following the 1978 appreciation of the yen, consumption increased at an inflation-adjusted annual rate of 7.5 percent. Despite a slight drop in the growth of nominal income from fiscal 1977 to fiscal 1978, the fall in the inflation rate from 6.8 percent to 3.4 percent boosted real income and consumer spending.

It is unclear, though, whether the recent appreciation of the yen will lead to an equally sharp dip in the inflation rate. In December the government predicted that the rise in the consumer price index would fall from an already low 2.1 percent in FY 1985 to 1.9 percent in FY 1986. Furthermore, the prospects for wage increases are uncertain. While the unions are pushing for at least a 7 percent hike during the annual spring wage bargaining, the chairman of the Japan Federation of Employers' Associations, Bunpei Ohtsuki, has argued for a 3 percent rise. Forecasters such as *Nihon Keizai Shimbun* and Nomura Research Institute expect a 4.5 to 4.8 percent increase, which would be less than last year's 5 percent rise.

This year, though, the government has clearly indicated its support for a large wage increase to stimulate domestic demand. The prime minister's Industrial Structure Council recently noted that "both nominal and real wage increases in 1983 and 1984 trailed the rise in productivity," and called for a larger share of national income for wages.

Randall S. Jones

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	1984	1985	January-March 1985	April-June 1985	July-September 1985	October-December 1985
Gross National Product	Y278,118.6 (5.1%)	Y291,039.3 (4.6%)	Y285,425.7 (1.7%)	Y289,447.6 (5.8%)	Y291,588.4 (3.0%)	Y296,667.1 (7.2%)
Personal Consumption Spending	158,124.5 (2.8%)	162,439.9 (2.7%)	161,106.4 (4.8%)	161,900.4 (2.0%)	162,777.8 (2.2%)	163,650.2 (2.2%)
Private Residential Construction	13,619.1 (-2.1%)	14,056.2 (3.2%)	13,913.9 (5.1%)	14,227.9 (9.3%)	13,881.0 (-9.4%)	14,186.5 (9.1%)
Private Fixed Nonresidential Investment	46,277.4 (10.9%)	52,114.8 (12.6%)	48,574.5 (1.0%)	51,124.5 (22.7%)	53,189.7 (17.2%)	55,300.4 (16.8%)
Change in Business Inventories	1,609.6 (102.3%)	1,812.7 (12.6%)	2,112.0 (37.4%)	1,825.3 (-44.2%)	1,438.2 (-61.4%)	1,882.1 (193.3%)
Government Current Expenditures	26,471.3 (2.5%)	27,146.9 (2.6%)	26,979.1 (4.6%)	27,081.5 (1.5%)	27,192.9 (1.7%)	27,342.9 (2.2%)
Government Fixed Investment	22,374.4 (-2.9%)	20,831.2 (-6.9%)	21,615.5 (-7.1%)	19,954.0 (-27.4%)	20,495.6 (11.3%)	20,917.3 (8.5%)
Change in Government Inventories	162.8 (*)	305.9 (*)	27.9 (*)	77.6 (*)	515.6 (*)	604.7 (*)
Net External Sector	9,479.7 (59.3%)	12,331.7 (30.1%)	11,096.4 (-29.2%)	13,256.4 (103.7%)	12,097.6 (-30.6%)	12,783.0 (24.7%)
Exports of Goods and Services and Factor Income Received	52,365.0 (17.5%)	55,446.5 (5.9%)	54,833.7 (-3.0%)	57,176.9 (18.2%)	55,077.6 (-13.9%)	54,654.4 (-3.0%)
Imports of Goods and Services and Factor Income Paid	42,885.3 (11.1%)	43,114.9 (0.5%)	43,737.3 (5.5%)	43,920.5 (1.7%)	42,980.0 (-8.3%)	41,871.4 (-9.9%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

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JAPAN'S EXPANDING U.S. MANUFACTURING PRESENCE: 1985 UPDATE

Summary

The drumbeat of criticism by Washington about the trade practices of Japanese corporations is drowning out some good economic news about the same companies from state capitals across the country: more and more Japanese businesses are making the products they sell here in U.S. plants. In 1985 alone, 70 names were added to the list of American manufacturing companies owned wholly or in part by Japanese corporate investors. This expansion, by far the biggest one-year addition in the relatively brief history of Japanese investment, lifted the year-end total of Japanese-affiliated manufacturers in the United States to 435, including 30 companies in which businesses headquartered in Japan have minority interests. More importantly, Japan's expanding U.S. manufacturing presence means jobs -- close to 100,000 of them in industries ranging from metals and motor vehicles to communications and computer equipment, integrated circuits, consumer electronics and food products.

Japan's 1985 Investments in U.S. Production Facilities

Japanese investment in U.S. production facilities has developed a momentum of its own. This conclusion might seem premature since Japanese corporations have only been active investors in this country's manufacturing sector for the last 10 years. But no other explanation fits the bill given the investment climate in 1985. At that time just as many of the factors Japanese executives weigh in considering assembly or manufacturing operations in the United States indicated waiting rather than investing.

The bumpy slowdown in the U.S. economic expansion last year weakened the pull of what was perhaps the single largest cause of 1984's then-record level of Japanese investment activity -- the strength and seeming durability of the recovery here. Similarly, the weakness of the yen until late September curtailed the push that had propelled Japanese corporations to invest in the United States during the first half of 1984 since it both upped the price of building new plants or acquiring existing ones and reduced the cost of supplying the American market through exports.

At first glance, the double-digit hike in Japanese capital spending for the second straight year provided grounds to assume that Japanese companies would step up their manufacturing investments in this country. This reasoning is debatable, however, if only because the increasing pace of deregulation at home opened up new investment opportunities there for Japanese businesses. Neither can the fresh outbreak of protectionist rhetoric in Washington be assigned the decisive role that some ascribe to it. Whatever the political pressures, Japanese firms will not put money into American production facilities unless they are convinced that these investments are economically sound.

Against this backdrop the results of the Japan Economic Institute's sixth annual survey of Japanese investment activity in the U.S. manufacturing sector are something of a surprise. A record-breaking 64 Japanese majority-owned companies joined the ranks of domestic assembly or manufacturing concerns during 1985, 23 more than the year before and almost three times greater than 1982's recession-curbed total. Equally eye-catching, eight firms already turning out products in the United States started work on new factories or acquired additional plants, while a long list of other producers invested in capacity expansion at their existing facilities. Moreover, Japanese corporations, which had shied away from minority investments in American production firms in both 1982 and 1983, obtained shares of at least 10 percent but less than 50 percent in six businesses last year, although this was two less than in 1984.

New plant construction remained the preferred investment route, outnumbering acquisitions by a two-to-one margin. This was the same ratio that had prevailed in the period through 1980 and again in 1983, but in the intervening years the investment mix first tilted toward an even split (1981 and 1982) and then swung in the opposite direction, hitting a four-to-one breakdown in 1984.

Like their predecessors, last year's newcomers, especially the fast-increasing number of small and medium-sized companies, almost uniformly decided to start from the ground up, in large part because their initial U.S. operations are limited to final assembly work. But even big Japanese corporations that are established producers in this country -- companies like Canon Inc., Fujitsu, Ltd., Hitachi, Ltd., Pioneer Electronic Corp. and Toshiba Corp. as well as C. Itoh & Co., Ltd. and Mitsubishi Corp. -- went the new investment route.

While Japanese corporate investors were by no means on the same acquisition binge in 1985 as their American counterparts, they did take over a record

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21 U.S. manufacturing companies. The vast majority of these acquisitions were routine business transactions. But one -- the purchase of New Hampshire Ball Bearings Inc., an important supplier of bearings for defense production, by Minebea Co., Ltd., itself a leading maker of precision bearings -- reignited the controversy in Washington about foreign firms controlling American companies that do work considered vital to U.S. national security interests.

Whether newcomers or repeat investors, Japanese companies continued to opt in most cases for wholly owned production units rather than joint manufacturing ventures with American businesses. Yet the mutual benefits that can be derived from production tie-ups -- access to first-hand knowledge of the U.S. market for Japanese firms and help with product and/or process technology for American competitors -- are making joint ventures a more frequent occurrence. In 1985, for example, 14 of the majority-owned companies established by Japanese investors were partnerships. Most involved firms unknown outside their industry, but a few paired companies with familiar names, like Mitsubishi Motors Corp. and Chrysler Corp. or Toshiba and Westinghouse Electric Corp. Japanese corporations also teamed up with American companies in another six businesses by buying a majority interest.

Japan's Manufacturing Holdings in the United States: The New Count

At the end of 1985, Japanese corporate investors had a stake of 50 percent or more in 405 U.S. assembly or manufacturing companies, including 32 scheduled to go onstream later this year or in 1987. While small and medium-scale operations are the rule, an increasing number of firms qualify as big businesses, whether measured by sales, investment, employment or all three indicators. Ironically perhaps, the two biggest are joint ventures: National Steel Corp., which is half owned by Nippon Kokan K.K., and Alumax Inc., a partnership of Mitsui & Co., Ltd., Nippon Steel Corp. and AMAX Inc. This country's sixth-largest integrated steel producer with 1985 sales of $2.1 billion, National Steel employs 12,000 people at its three Midwestern mills. The sales and employment numbers for Alumax, one of the top three U.S. producers of primary aluminum and a leading maker of fabricated aluminum products, closely match these figures, but the company's workforce is scattered among 89 facilities in 29 states.

Other big ventures include the three Japanese automotive assembly plants currently in operation in the United States. Honda of America Manufacturing, Inc. is gearing up for production of 150,000 subcompact cars a year at its Ohio plant, which will continue to turn out the same number of compacts. This expansion is expected to add several hundred workers to the 2,300 already employed. Nissan Motor Manufacturing Corp. U.S.A. is also increasing output at its Tennessee factory, moving toward full-capacity production of 240,000 small pickup trucks and subcompact cars a year by the end of 1986 with 3,100 employees. For its part, New United Motor Manufacturing Inc., the California-based joint venture between Toyota Motor Corp. and General Motors Corp., has reached full operation, assembling 200,000 cars annually with a workforce of 2,500 for sale through Chevrolet dealers.

Some of the consumer electronics companies also number among the largest Japanese manufacturing operations in this country. Sony Manufacturing Corp. of America employs 1,600 at its San Diego, California color television plant, while the Alabama cassette tape factory operated by Sony Magnetic Products Inc.

has 1,300 workers. Two manufacturers of color televisions and microwave ovens -- Sanyo Manufacturing Corp. and Matsushita Industrial Co. -- are big concerns as well, with Arkansas-based Sanyo employing 1,800 and Matsushita 1,500 at its facility in the Chicago, Illinois suburbs. Rounding out the list of major investments are Kyocera International, Inc., which has 1,800 employees at three plants in San Diego, California that make ceramic packages for integrated circuits and electronic components, and newcomer New Hampshire Ball Bearings, which has over 1,900 people on its five-plant New Hampshire payroll.

The 405 U.S. assembly or manufacturing companies in which Japanese investors owned a majority stake at year-end 1985 had 583 plants in operation or under construction at that time. California was home to 153 plants, but it lost some ground last year in the stiff state competition for Japanese investment, adding just five, primarily small, new facilities plus six acquired ones. Five additional plants that boosted its total to 37 helped Georgia take the runner-up title away from Texas, which dropped to third place with 36 factories. New Jersey, the location of 31 plants, held on to the number-four position as four plants were built or acquired in the state. The same number of additions gave Illinois fifth place with 26 facilities. Michigan and Ohio moved up two slots as seven more plants in each state lifted their totals to Washington State's 23. There was also a three-way tie for seventh place -- 20 factories -- among New York, North Carolina and Pennsylvania. Trailing this trio were Tennessee (15) and Indiana (13), with Alaska, the site of 12 operations, occupying the tenth position.

While company and plant numbers give some idea of the magnitude of Japan's corporate stake in the U.S. manufacturing sector, employment figures are a more revealing indicator. The 373 majority-owned manufacturing concerns already in operation have close to 100,000 people on their payrolls. Another 10,800 or so jobs will be generated when plants now under construction go onstream, including 3,500 alone at Mazda Motor Manufacturing (USA) Corp.'s suburban Detroit, Michigan plant and 2,500 at the Illinois facility of Diamond-Star Motors Corp., the Mitsubishi Motors-Chrysler venture. Several thousand other jobs will open up as established manufacturers complete their current expansion programs. With Japanese investors also creating or maintaining jobs by taking minority positions in 30 U.S. manufacturing companies, it is safe to assume that 120,000 Americans will soon owe their jobs to Japanese-affiliated manufacturers in this country.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

JEI's Investment Survey

The Japan Economic Institute's study of U.S. manufacturing companies owned by or affiliated with Japanese investors was limited to firms that had plants in operation or under construction on December 31, 1985. This cut-off date eliminated a number of companies that had definite plans to build production facilities in the United States but had not broken ground by year end, as well as several acquisitions that had not been finalized.

The results of the 1985 update survey are contained in three appendices, which also include the information from the four previous updates. The main appendix gives, in alphabetical order, the full name of each U.S. manufacturing company owned wholly or in part by Japanese investors; the location of its plant or plants; the full name of what is known as the company's ultimate beneficial owner(s); the share of stock held by the owner(s); whether the company was a new investment or an acquisition; the company's major product line(s); the approximate or actual number of people employed by the company, if available; and when the company began production or, in the case of acquisitions, when the company was bought by Japanese investors. The second appendix presents a state-by-state listing of plant locations, while the third groups the products made in terms of four-digit Standard Industrial Classification codes.

Note

The following appendices only include companies that have been added since the 1980 benchmark study was published. For a complete list of U.S. manufacturing companies owned by or affiliated with Japanese investors, it is necessary to consult the benchmark study as well as the attached appendices.

Appendix 1: Alphabetic Listing of U.S. Manufacturing Affiliates of Japanese Companies

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
●AMTEX Inc.	Manteca, CA	Hayashi Telempu Co., Ltd. C.H. Masland & Sons	50% 50	New	Automotive floor mats, door trim/ other interior trim products	50*	1986*
●AP Technoglass Corp.	Bellefontaine, OH	Asahi Glass Co., Ltd. PPG Industries, Inc.	80 20	New	Automotive safety glass	100*	1987*
ASTRONET Corp.	Lake Mary, FL	Mitsubishi Electric Corp. Mitsubishi Corp. Plessey Co., PLC	25 24 51	New	Cellular mobile communications equipment	50	1984
ATR Wire and Cable Co.	Danville, KY	Tokyo Rope Manufacturing Co., Ltd. Mitsubishi Corp. C. Itoh & Co., Ltd.	60 20 20	Acquired	Steel cord/bead wire for tires	680	1981
●Aderans & Alfieri Inc.	New York, NY	Aderans Ltd.	80	Acquired	Men's custom hairpieces	28	1985
●Airin Inc.	Los Angeles, CA	Airin Co., Ltd. Mitsui & Co., Ltd.	70 30	New	Rice crackers	15	1985
●Alcoa Conductor Accessories Inc.	Spartanburg, SC	Fujikura Ltd. Aluminum Co. of America	20 80	New	Accessories for overhead transmission lines	100	1985
●Alcoa Fujikura Ltd.	Spartanburg, SC	Fujikura Ltd. Aluminum Co. of America	49 51	New	Fiber-optic cables		1985
Alerco and Hayward Steel, Inc.	Hayward, CA	Kawasho Corp.	100	Acquired	Sheet-metal ducts	80	1979
●Alerco and Hayward Steel, Inc.	Union City, CA	Kawasho Corp.	100	Acquired	Sheet-metal ducts, fabricated plate work		1985
Alloy Tool Steel Inc.	Santa Fe Springs, CA	Nissho Iwai Corp. Nippon Koshuha Steel Co., Ltd.	55 35	New	Steel processing	30	1974
Alloy Tool Steel of Texas Inc.	Hutchins, TX	Nissho Iwai Corp. Nippon Koshuha Steel Co., Ltd.	28 18	New	Steel processing	5	1981
Alpha Biochemical Corp.	Richland, WA	Kanegafuchi Chemical Industry Co., Ltd.	100	New	Binder for fish feed	20	1982
Alpine Electronics of America, Inc.	Torrance, CA	Alps Electric Co., Ltd.	100	New	Automotive audio equipment	15	1984
●Alps Electric (U.S.A.), Inc.	Garden Grove, CA	Alps Electric Co., Ltd.	100	Acquired	Computer keyboards, mouse input devices	125	1985
Alumax Inc.		Mitsui & Co., Ltd. Nippon Steel Corp. AMAX Inc.	45 5 50	Acquired			1974
Alumax Aluminum Corp.	Hawesville, KY	Alumax Inc.	100	Acquired	Aluminum sheet	n.a.	1983
Alumax Aluminum Corp.	Lancaster, PA	Alumax Inc.	100	Acquired	Aluminum sheet	n.a.	1983
Alumax Extrusions, Inc.	Catawaba, NC	Alumax Inc.	100	New	Aluminum extruded shapes	n.a.	1981
Alumax Extrusions, Inc.	Rockwall, TX	Alumax Inc.	100	Acquired	Secondary aluminum billet	n.a.	1983
Alumax Extrusions, Inc.	Rockwall, TX	Alumax Inc.	100	Acquired	Aluminum extruded shapes	n.a.	1983
Alumax Fabricated Products, Inc.	Anaheim, CA	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket	n.a.	1981
Alumax Fabricated Products, Inc.	Sacramento, CA	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket	n.a.	1981
Alumax Fabricated Products, Inc.	Alma, GA	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket/mobile homes	n.a.	1984

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
Alumax Fabricated Products, Inc.	Tifton, GA	Alumax Inc.	100	Acquired	Aluminum products for mobile homes/ recreational vehicles	n.a.	1983
Alumax Fabricated Products, Inc.	Elkhart, IN	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket/mobile homes	n.a	1984
Alumax Fabricated Products, Inc.	Leola, PA	Alumax Inc.	100	Acquired	Aluminum products for mobile homes/ recreational vehicles	n.a.	1983
Alumax Fabricated Products, Inc.	Clarkesville, TX	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket/mobile homes	n.a.	1984
Alumax Mill Products, Inc.	Texarkana, TX	Alumax Inc.	100	New	Recycled aluminum scrap	n.a.	1986*
Alumax Mill Products, Inc.	Texarkana, TX	Alumax Inc.	100	New	Aluminum container sheet	n.a.	1986*
Home and Specialty Products Group	Magnolia, AR	Alumax Inc.	100	Acquired	Aluminum spectator seating, scaffolding, bath enclosures/ ceiling grid systems	n.a.	1983
Home and Specialty Products Group	Hayward, CA	Alumax Inc.	100	Acquired	Aluminum bath enclosures	n.a.	1983
Home and Specialty Products Group	Tampa, FL	Alumax Inc.	100	Acquired	Aluminum bath enclosures	n.a.	1983
Home and Specialty Products Group	Stone Mountain, GA	Alumax Inc.	100	Acquired	Aluminum bath enclosures	n.a.	1983
Home and Specialty Products Group	Dallas, TX	Alumax Inc.	100	Acquired	Aluminum bath enclosures	n.a.	1983
Home and Specialty Products Group	Sacramento, CA	Alumax Inc.	100	Acquired	Aluminum rain-carrying components other building products	n.a.	1983
Home and Specialty Products Group	Tucker, GA	Alumax Inc.	100	Acquired	Aluminum rain-carrying components other building products	n.a.	1983
Home and Specialty Products Group	Lancaster, PA	Alumax Inc.	100	Acquired	Aluminum rain-carrying components other building products	n.a.	1983
Home and Specialty Products Group	Grand Prairie, TX	Alumax Inc.	100	Acquired	Aluminum rain-carrying components other building products	n.a.	1983
Home and Specialty Products Group	Cerritos, CA	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket	n.a.	1983
Home and Specialty Products Group	Fremont, CA	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket	n.a.	1983
Home and Specialty Products Group	Lithonia, GA	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket	n.a.	1983
Home and Specialty Products Group	Bedford Park, IL	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket, aluminum rain-carrying components/other building products	n.a.	1983
Home and Specialty Products Group	Kansas City, MO	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket	n.a.	1983
Home and Specialty Products Group	Harrisburg, PA	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket	n.a.	1983
Home and Specialty Products Group	Leola, PA	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket	n.a.	1983
Home and Specialty Products Group	Mesquite, TX	Alumax Inc.	100	Acquired	Aluminum products for housing aftermarket	n.a.	1983
Kawneer Co., Inc.	Springdale, AR	Alumax Inc.	100	New	Architectural aluminum products	n.a.	1981
Kawneer Co., Inc.	Aurora, CO	Alumax Inc.	100	New	Architectural aluminum products	n.a.	1963
•Kawneer Co., Inc.	Boonsburg, NC	Alumax Inc.	100	New	Architectural aluminum products	n.a.	1985
Kawneer Co., Inc.	Houston, TX	Alumax Inc.	100	New	Architectural aluminum products	n.a.	1982

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
Prime Metals Division	Atlanta, GA	Alumax Inc.	100	Acquired	Aluminum/copper/steel processing	n.a.	1983
Prime Metals Division	Fraser, MI	Alumax Inc.	100	Acquired	Aluminum/copper/steel processing	n.a.	1983
Prime Metals Division	Grand Rapids, MI	Alumax Inc.	100	Acquired	Aluminum/copper/steel processing	n.a.	1983
Prime Metals Division	Kansas City, MO	Alumax Inc.	100	Acquired	Aluminum/copper/steel processing	n.a.	1983
Prime Metals Division	Brecksville, OH	Alumax Inc.	100	Acquired	Aluminum/copper/steel processing	n.a.	1983
Prime Metals Division	Mesquite, TX	Alumax Inc.	100	Acquired	Aluminum/copper/steel processing	n.a.	1983
Amano-International Enzyme Co., Inc.	Troy, VA	Amano Pharmaceutical Co., Ltd.	100	New	Enzymes	10	1981
American Foods Corp.	Rancho Cucamonga, CA	Nakano Vinegar Co., Ltd.	100	New	Vinegar		1984
American Foods Corp.	San Francisco, CA	Nakano Vinegar Co., Ltd.	100	Acquired	Vinegar, cooking wines, sauces	75	1981
American Foods Corp.	Watsonville, CA	Nakano Vinegar Co., Ltd.	100	Acquired	Vinegar		1981
●American Fuji Seal, Inc.	Fairfield, NJ	Fuji Seal Industry Co., Ltd.	100	New	Heat-shrink labels, rotogravure cylinders	n.a.	1985
●American Yazaki Corp.	Canton, MI	Yazaki Corp.	100	New	Automotive wire harnesses	150	1986
Amitech Inc.	Marietta, GA	Mitsui & Co., Ltd. Nypro Inc.	50 50	New	Plastic parts for electronics industry/medical uses	65	1981
Amsnack, Inc.	Stockton, CA	Chuoken Sembei Inc.	100	New	Rice crackers	18	1981
Ando Screen Inc.	North Canton, OH	Ando Screen Co., Ltd.	100	New	Screening equipment for liquid-solid separation	15	1985
●K.N. Aronson Inc.	Arcade, NY	Koike Sanso Kogyo Co., Ltd. Nippon Sanso K.K.	67 33	Acquired	Welding positioners, gas-cutting equipment	163	1985
●Atari Games Corp.	Milpitas, CA	Namco K.K. Warner Communications Inc.	Majority share Minority share	Acquired	Coin-operated video game machines	170	1985
●Barudan America Inc.	Cleveland, OH	Barudan Co., Ltd.	100	Acquired	Monogramming/embroidery machinery	15	1985
Bellemar Parts Industries Inc.	Marysville, OH	Honda Motor Co., Ltd. Sankei Giken Kogyo Co., Ltd. Tokyo Seat Co., Ltd.	80 10 10	New	Automotive/motorcycle seats, wheels	170	1982
Bellemar Parts Industries Inc.	Russells Point, OH	Honda Motor Co., Ltd. Sankei Giken Kogyo Co., Ltd. Tokyo Seat Co., Ltd.	80 10 10	New	Automotive exhaust systems, catalytic converters, brake lines, door sashes, seat frames	140	1985
●Belletech Corp.	Bellefontaine, OH	Asahi Glass Co., Ltd. Takahashi Glass Industry Co., Ltd. PPG Industries, Inc.	60 20 20	New	Automotive glass fittings	70*	1986*
Bering Sea Fisheries, Inc.	Mouth of Yukon, AK	Marubeni Corp.	25	Acquired	Frozen fish	40	1972
●Berwick Steel Co.	Columbus, OH	Nissho Iwai Corp.	100	Acquired	Steel processing	90	1985
Bio Kyowa Inc.	Cape Girardeau, MO	Kyowa Hakko Kogyo Co., Ltd.	100	New	Lysine (feedstuff amino acid additive)	74	1984
●Bleim Steel Co.	Toledo, OH	Marubeni Corp.	100	Acquired	Steel processing	55	1985
Bridgestone (USA) Inc.	LaVergne, TN	Bridgestone Corp.	100	Acquired	Radial truck/bus tires	1,100	1982
Bunmeido of Hawaii Ltd.	Honolulu, HI	Bunmeido Confectionery Co., Ltd.	100	New	Bakery products	8	1965
●CKR Industries, Inc.	Winchester, TN	Kinugawa Rubber Industrial Co., Ltd. Chardon Rubber Co.	40 60	New	Automotive extruded rubber products	115*	1986*

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
●C&M Fine Pack Inc.	San Bernardino, CA	Chuo Kagaku Co., Ltd. Watanabe Kosan Co., Ltd. Mitsubishi Corp.	40 20 40	New	Plastic containers	150*	1986*
California Steel Industries Inc.	Fontana, CA	Kawasaki Steel Corp. Cia Vale do Rio Doce S.A.	25 25	Acquired	Hot-rolled, cold-rolled/galvanized steel sheets/coils, hot-rolled steel plates	725	1984
Calsonic Manufacturing Corp.	Shelbyville, TN	Nihon Radiator Co., Ltd.	100	New	Automotive air conditioners, exhaust assemblies	200	1983
●Canon Virginia Inc.	Newport News, VA	Canon Inc.	100	New	Copiers	100*	1987*
Cast Forge Co.	Howell, MI	Nippon Light Metal Co., Ltd. Kelsey-Hayes Co.	20 80	Acquired	Aluminum wheels/other die-cast automotive parts	100	1982
Chateau St. Jean	Kenwood, CA	Suntory Ltd.	100	Acquired	Wine	100	1984
Chickasha Cotton Oil Co.	Casa Grande, AZ	Toyo Menka Kaisha, Ltd.	100	Acquired	Cottonseed oil	1,000	1981
Chickasha Cotton Oil Co.	Clinton, OK	Toyo Menka Kaisha, Ltd.	100	Acquired	Cottonseed oil		1981
Chickasha Cotton Oil Co.	Harlingen, TX	Toyo Menka Kaisha, Ltd.	100	Acquired	Cottonseed oil		1981
Chickasha Cotton Oil Co.	Lamesa, TX	Toyo Menka Kaisha, Ltd.	100	Acquired	Cottonseed oil		1981
Clarion Corp. of America	Nashville, TN	Clarion Co., Ltd.	100	New	Automotive audio equipment	3	1982
Coca-Cola Bottling Co.	Salem, NH	Kirin Brewery Co., Ltd.	100	Acquired	Soft drinks	215	1982
CoilPlus, Inc.	Athens, AL	Mitsubishi Corp.	100	New	Steel processing	50	1985
Concise Casting Corp.	Hayward, CA	Hitachi Metals, Ltd.	100	Acquired	Aluminum castings	95	1981
Cryodynamics Co.-Ebara Group	Sacramento, CA	Ebara Corp.	70	New	Pumps for low-temperature liquids	30	1984
Curtis-Maruyasu America, Inc.	Tracy, CA	Maruyasu Industries Co., Ltd. Curtis Products, Inc.	50 50	New	Automotive fuel line/hydraulic brake assemblies	25	1985
Daiichiya Love's Bakery Inc.	Honolulu, HI	Daiichiya Baking Co., Ltd.	100	Acquired	Bakery products	240	1981
Dainippon Screen Engineering of America Inc.	Santa Ana, CA	Dainippon Screen Mfg. Co., Ltd.	100	New	Electronic page makeup systems/color scanners for graphic arts industry	20	1984
Daiwa Golf Co.	Gardena, CA	Daiwa Seiko, Inc.	100	New	Golf clubs	20	1981
Data Ray Corp.	Boulder, CO	Nippon Chemi-Con Corp.	75	Acquired	CRT display modules	50	1983
Diamond Plastics Corp.	Grand Island, NE	Mitsubishi Corp.	100	Acquired	Polyvinyl chloride pipes	115	1982
Diamond Plastics Corp.	Lubbock, TX	Mitsubishi Corp.	100	Acquired	Polyvinyl chloride pipes		1982
●Diamond-Star Motors Corp.	Bloomington-Normal, IL	Mitsubishi Motors Corp. Chrysler Corp.	50 50	New	Cars, automotive body stampings, automotive molded plastics parts	2,500*	1988*
Digital Audio Disc Corp.	Terre Haute, IN	Sony Corp.	100	New	Digital audio discs	300	1984
Dutch Harbor Seafoods Co., Inc.	Dutch Harbor, AK	Nippon Suisan Kaisha Ltd.	25	New	Frozen fish	200	1976
●EVAL Co. of America	Pasadena, TX	Kuraray Co., Ltd. Norchem Inc.	50 50	New	Ethylene vinyl alcohol copolymer resins	50*	1986*
Economic Salon, Ltd.	New York, NY	Keizai Salon Co., Ltd.	100	New	Periodicals publishing	10	1971
●Electro-Plasma, Inc.	Irvine, CA	Nippon Steel Corp.	75	Acquired	Plasma spray equipment	35	1985
●Enkenei America Inc.	Columbus, IN	Enshu Keigokin Co., Ltd. Mitsubishi Corp.	60 40	New	Aluminum automotive wheels	80*	1986*
Enway Inc.	Clackamas, OR	Restaurant Skylark Co., Ltd.	51	New	Frozen potato products	10	1982
●Epson Portland Inc.	Hillsboro, OR	Seiko Epson Corp.	100	New	Computer printers	170*	1986*
FEC Inc.	Madison Heights, MI	Dai-Ichi Dentsu Co., Ltd.	100	New	Electronic fastening systems	25	1983
First Metals, Inc.	Houston, TX	Toyo Menka Kaisha, Ltd.	100	New	Steel processing	22	1978

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
Fuji Cone Inc.	Clinton, NC	Fuji Cone Works Ltd. International Jensen Inc.	50 50	New	Paper cones for stereo speakers	85	1981
Fuji Foods Inc.	Browns Summit, NC	Fuji Foods Corp.	100	New	Beef/chicken extracts for soup stocks	16	1983
Fuji Koki America Inc.	Dallas, TX	Fuji Koki Mfg. Co., Ltd.	100	New	Expansion valves for automotive air conditioning systems	32	1982
Fujitec Industries, Inc.	Lebanon, OH	Fujitec Co., Ltd.	100	New	Elevators, escalators	100	1983
Fujitsu America, Inc.	Palm Bay, FL	Fujitsu, Ltd.	100	New	Cable assemblies, power supply units/related components for computers/peripheral equipment	50	1981
•Fujitsu America, Inc.	Hillsboro, OR	Fujitsu, Ltd.	100	New	Computer disk drives	400*	1986*
Fujitsu America, Inc.	Richardson, TX	Fujitsu, Ltd.	100	New	Cellular mobile/fiber-optic communications equipment, multiplexers, microwave radios	150	1984
•GMF Robotics Corp.	Rochester Hills, MI	Fanuc Ltd. General Motors Corp.	50 50	New	Robotic systems	800*	1986*
•Great Land Seafoods Inc.	Dutch Harbor, AK	Nippon Suisan Kaisha Ltd.	100	New	Surimi (boiled fish paste)	130	1986
•Great Western Silicon Corp.	Chandler, AZ	Nippon Kokan K.K.	100	Acquired	Polycrystalline silicon	44	1985
Heartland Lysine, Inc.	Eddyville, IA	Ajinomoto Co., Inc. Orsan S.A.	50 50	New	Lysine (feedstuff amino acid additive)	50*	1986*
Hemlock Semiconductor Corp.	Hemlock, MI	Shin-Etsu Handotai Co., Ltd. Mitsubishi Metal Corp. Dow Corning Corp.	24.5 12.25 63.25	Acquired	Polycrystalline silicon	225	1984
High Voltage Breakers, Inc.	Norcross, GA	Hitachi, Ltd. General Electric Co.	67 33	New	Circuit breakers for power plants/transmission lines	15	1982
Hirose Electric (U.S.A.), Inc.	Chatsworth, CA	Hirose Electric Co., Ltd.	100	New	Connectors	2	1985
•Hishi Plastics U.S.A., Inc.	Lincoln Park, NJ	Mitsubishi Plastics Industries Ltd. Mitsubishi Corp.	51 49	New	Polyvinyl chloride heat-shrinkable tubing	20	1985
•Hitachi Automotive Products (USA) Inc.	Harrodsburg, KY	Hitachi, Ltd.	100	New	Ignition coils/electronic automotive components	50*	1986*
Hitachi Chemical Co. America, Inc.	Tucker, GA	Hitachi Chemical Co., Ltd.	100	New	Multiwire boards	60	1985
•Hitachi Computer Products (America) Inc.	Norman, OK	Hitachi, Ltd.	100	New	Computer disk drives	100*	1987*
Hitachi Consumer Products of America Inc.	Anaheim, CA	Hitachi, Ltd.	100	New	Color television sets	400	1982
Hi-Tek Corp.	Garden Grove, CA	Minebea Co., Ltd.	100	Acquired	Computer keyboards	130	1983
Honda of America Manufacturing, Inc.	Anna, OH	Honda Motor Co., Ltd.	100	New	Motorcycle engines	100	1985
Honda Power Equipment Manufacturing Inc.	Swepsonville, NC	Honda Motor Co., Ltd.	100	New	Lawnmowers	100	1984
Honma Golf, Inc.	Honolulu, HI	Honma Corp.	100	New	Golf clubs	36	1978
•Hoshizaki America, Inc.	Peachtree City, GA	Hoshizaki Electric Co., Ltd.	100	New	Ice machines	80*	1987*
House Foods and Yamauchi Inc.	Los Angeles, CA	House Food Industrial Co., Ltd.	50	Acquired	Tofu/related soybean products	40	1983

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
•IB Chemical Co.	Mobile, AL	Mitsubishi Chemical Industries, Ltd. Mitsubishi Corp. Virginia Chemicals Inc.	35 15 50	New	Slow-release nitrogen fertilizers	25	1985
IDEC Systems & Controls Corp.	Santa Clara, CA	Izumi Denki Corp.	100	New	Relays, sockets, switches/other electrical industrial components	70	1975
IKS American Corp.	Gardena, CA	Izumoto Seiko Co., Ltd.	100	New	Ball bearings	18	1974
•IMC Magnetics Corp.	Miami Lakes, FL	Minebea Co., Ltd.	100	Acquired	Power supplies for computers/ other equipment	220	1985
International Leadframe Corp.	Sunnyvale, CA	Mitsui Mfg. Co., Ltd.	100	New	Lead frames for integrated circuits	21	1980
International Light Metals Corp.	Torrance, CA	Nippon Kokan K.K. Martin Marietta Corp.	40 60	Acquired	Aluminum/titanium bars, extrusions/ forgings	1,750	1985
International Titanium Inc.	Moses Lake, WA	Mitsui & Co., Ltd. Wyman-Gordon Co.	22.55 77.45	New	Titanium sponge	192	1982
•Isuzu Truck of America Inc.	Russellville, KY	Isuzu Motors, Ltd. C. Itoh & Co., Ltd.	80 20	New	Bus chassis	30*	1987*
•C. Itoh Steel Inc.	Winchester, KY	C. Itoh & Co., Ltd.	100	New	Steel processing	20*	1986*
Iwatsu America Inc.	Carlstadt, NJ	Iwatsu Electric Co., Ltd.	100	New	Key telephone systems, push-button telephones	n.a.	1984
Japan Aircraft Maintenance (America), Inc.	Mukilteo, WA	New Japan Aircraft Maintenance Co., Ltd.	100	New	Aircraft interior equipment	5	1982
KTH Parts Industries Inc.	St. Paris, OH	Kikuchi Press Kogyo Co., Ltd. Takao Kinzoku Kogyo Co., Ltd. Hirata Press Kogyo Co., Ltd. Hongo Seisakusho Co., Ltd.	100	New	Automotive stamped/welded internal structural components	100	1985
Kaga USA Inc.	Fountain Valley, CA	Kaga Tsushin Kogyo Co., Ltd.	100	New	Lead frames/other metal parts for integrated circuits	10	1982
Kameyama U.S.A. Inc.	Fall River, MA	MAS Co., Ltd.	Majority share	New	Candles	15	1985
Kaneka Texas Corp.	Bayport, TX	Kanegafuchi Chemical Industry Co., Ltd.	100	New	Methyl methacrylate-butadiene-styrene resins	80	1984
Kantus Corp.	Lewisburg, TN	Kanto Seiki Co., Ltd.	100	New	Automotive plastic instrument panels, radiator grilles, console/ glove boxes, bumpers/splash guards	150	1985
Kato Spring Inc.	Huntington Beach, CA	Kato Spring Works Co., Ltd.	100	New	Precision springs	10	1983
Kato Spring of Georgia Inc.	Norcross, GA	Kato Spring Works Co., Ltd.	100	New	Precision springs	8	1982
•Kawasaki and Nissho Iwai Partnership	Yonkers, NY	Kawasaki Heavy Industries, Ltd. Nissho Iwai Corp.	50 50	New	Subway cars	120	1986
•Kawasaki Thermal Systems, Inc.	Tacoma, WA	Kawasaki Steel Corp. General Electric Co.	75 25	Acquired	Insulated oilfield pipe	35	1985
Kel-Am, Inc.	Eldon, MO	Kel Corp.	100	New	Connectors	85	1978
•Kentwood Spring Water Inc.	New Orleans, LA	Suntory Ltd.	100	Acquired	Bottled water	100	1985
Kibun Corp. of North Carolina	Raleigh, NC	Kibun Co., Ltd.	100	New	Frozen imitation crab products	16	1984
Kibun Corp. of Washington	Redmond, WA	Kibun Co., Ltd.	100	New	Frozen imitation crab products	44	1983
Kikusui International Corp.	Gardena, CA	Kikusui Electronics Corp.	100	New	Oscilloscopes	20	1983

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
•Koltron Corp.	Sunnyvale, CA	Nippon Mining Co., Ltd.	37	Acquired	Lead frames for integrated circuits	165	1985
•Komatsu America Manufa turing Corp.	Chattanooga, TN	Komatsu Ltd.	100	New	Construction/mining equipment	250*	1986*
Kubota Tractor Corp.	Norcross, GA	Kubota, Ltd.	100	New	Farm tractors	6	1984
•Kux Manufacturing Co.	Detroit, MI	Mitsubishi Corp.	100	Acquired	Self-adhesive lettering/decals for motor vehicles/industrial equipment	350	1985
Kyocera Northwest Inc.	Vancouver, WA	Kyocera Corp.	100	New	Ceramic capacitors	100	1985
•L-S Electro-Galvanizing Co.	Cleveland, OH	Sumitomo Metal Industries, Ltd. LTV Corp.	40 60	New	Galvanized steel sheets	70	1986
Lafayette Metal Service Corp.	Long Beach, CA	C. Itoh & Co., Ltd. Nuova Italsider S.p.A.	81 19	Acquired	Steel processing	70	1982
LeBlond Makino Machine Tool Co.	Cincinnati, OH	Makino Milling Machine Co., Ltd. LeBlond Inc.	51 49	Acquired	Numerically controlled lathes, machining centers, numerical controls	455	1981
LyphoMed Inc.	Melrose Park, IL	Fujisawa Pharmaceutical Co., Ltd.	22.5	Acquired	Injectable drugs	425	1985
MCI Optinix Inc.	Morristown, NJ	Mitsubishi Chemical Industries, Ltd.	100	Acquired	X-ray intensifying screens for medical use	15	1981
Machine Specialties Co.	Lincoln, RI	Bando Chemical Industries, Ltd.	100	Acquired	Pulleys	50	1979
•Makita Corp. of America	Buford, GA	Makita Electric Works, Ltd.	100	New	Cordless drills	40	1985
Maruhachi Ceramics of America	Corona, CA	Maruhachi Ceramics Co., Ltd.	100	New	Roofing tiles	30	1985
Master-Halco, Inc.	La Habra, CA	C. Itoh & Co., Ltd.	100	Acquired	Fittings for metal fencing	300	1977
Master-Halco, Inc.	Dallas, TX	C. Itoh & Co., Ltd.	100	Acquired	Chain link	200	1980
Matheson Gas Products Inc.	Cucamonga, CA	Nippon Sanso K.K. UGI Corp.	50 50	Acquired	Specialty gases, specialty gas handling equipment		1983
Matheson Gas Products Inc.	Newark, CA	Nippon Sanso K.K. UGI Corp.	50 50	Acquired	Specialty gases, specialty gas handling equipment		1983
Matheson Gas Products Inc.	Morrow, GA	Nippon Sanso K.K. UGI Corp.	50 50	Acquired	Specialty gases, specialty gas handling equipment		1983
Matheson Gas Products Inc.	Joliet, IL	Nippon Sanso K.K. UGI Corp.	50 50	Acquired	Specialty gases, specialty gas handling equipment		1983
Matheson Gas Products Inc.	Gonzales, LA	Nippon Sanso K.K. UGI Corp.	50 50	Acquired	Specialty gases, specialty gas handling equipment	400	1983
Matheson Gas Products Inc.	Gloucester, MA	Nippon Sanso K.K. UGI Corp.	50 50	Acquired	Specialty gases, specialty gas handling equipment		1983
Matheson Gas Products Inc.	E. Rutherford, NJ	Nippon Sanso K.K. UGI Corp.	50 50	Acquired	Specialty gases, specialty gas handling equipment		1983
Matheson Gas Products Inc.	Twinsburg, OH	Nippon Sanso K.K. UGI Corp.	50 50	Acquired	Specialty gases, specialty gas handling equipment		1983
Matheson Gas Products Inc.	La Porte, TX	Nippon Sanso K.K. UGI Corp.	50 50	Acquired	Specialty gases, specialty gas handling equipment		1983
Matsushita Communication Co.	Franklin Park, IL	Matsushita Communication Industrial Co., Ltd.	100	New	Cellular mobile communications equipment	24	1984
Matsushita Electric of Puerto Rico, Inc.	Caguas, PR	Matsushita Electric Industrial Co., Ltd.	100	New	Stereo speakers, record changers, speaker boxes, motors for phonographs/audio equipment, mobile paging devices	560	1965

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
●Mazda Motor Manufacturing (USA) Corp.	Flat Rock, MI	Mazda Motor Corp.	100	New	Cars, automotive body stampings, automotive molded plastic parts	3,500*	1987*
Megatool Inc.	Buena Park, CA	Union Tool Co., Ltd.	51	New	Carbide drills	17	1982
Memorex DIC Corp.	Santa Clara, CA	Dainippon Ink & Chemicals Inc. Burroughs Corp.	43 57	Acquired	Toner/developer for copiers, duplicators/printers	35	1981
●Menardi-Southern Corp.	Torrance, CA	Hosokawa Micron Corp.	100	Acquired	Fabric filter media for pollution control, product recovery, straining/separation, filter bags, filter cloths	227	1985
●Menardi-Southern Corp.	Augusta, GA	Hosokawa Micron Corp.	100	Acquired	Fabric filter media for pollution control, product recovery, straining/separation, filter bags, filter cloths		1985
●Menardi-Southern Corp.	Houston, TX	Hosokawa Micron Corp.	100	Acquired	Fabric filter media for pollution control, product recovery, straining/separation, filter bags, filter cloths		1985
Metco America Inc.	Axis, AL	Mitsubishi Rayon Co., Ltd. M&T Chemicals Inc.	Minority share Majority share	New	Impact modifiers for plastics industry	60	1985
●Mikropul Corp.	Summit, NJ	Hosokawa Micron Corp.	100	Acquired	Dust collection equipment, electrostatic precipitators, particle-size reduction equipment	186	1985
●Mitsubishi Consumer Electronics America, Inc.	Braselton, GA	Mitsubishi Electric Corp.	100	New	Cellular mobile communications equipment, color television sets	240*	1986*
Mitsubishi Foods Inc.	Ponce, PR	Mitsubishi Corp.	100	Acquired	Canned fish	850	1981
Mitsubishi Semiconductor America Inc.	Durham, NC	Mitsubishi Electric Corp.	100	New	Integrated circuits	250	1985
Mitutoyo Corp.	City of Industry, CA	Mitutoyo Mfg. Co., Ltd.	100	New	Calipers, micrometers	30	1979
Mizuno Golf Co.	Norcross, GA	Mizuno Corp.	100	New	Golf clubs	10	1985
●Mori Seiki U.S.A. Inc.	Irving, TX	Mori Seiki Co., Ltd.	100	New	Numerically controlled lathes, machining centers	30*	1986*
Musashi USA Inc.	Battle Creek, MI	Musashi Precision Industry Co., Ltd.	100	New	Automotive arm bushing/joint assemblies	5	1985
●NBK Corp.	Santa Clara, CA	Kawasaki Steel Corp.	100	Acquired	Silicon wafers	104	1985
NEC America, Inc.	Hawthorne, CA	NEC Corp.	100	New	Cellular mobile communications equipment, mobile paging devices	120	1975
NEC America, Inc.	Hillsboro, OR	NEC Corp.	100	New	Fiber-optic transmission systems, cellular mobile communications equipment/other telecommunications products	150	1985
NEC Electronics U.S.A. Inc.	Roseville, CA	NEC Corp.	100	New	Integrated circuits	500	1984
NEC Home Electronics (U.S.A.) Inc.	McDonough, GA	NEC Corp.	100	New	Color television sets	200	1985
NEC Information Systems Inc.	Boxborough, MA	NEC Corp.	100	New	Computers, computer printers	425	1983

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
NKK Switches of America, Inc.	Scottsdale, AZ	Nihon Kaiheiki Industries Co., Ltd.	Majority share	New	Electric/electronic switches	10	1983
NSG America Inc.	Somerset, NJ	Nippon Sheet Glass Co., Ltd.	100	New	Fiber-optic lens	11	1985
•NTN-Bower Corp.	Hamilton, AL	NTN Toyo Bearing Co., Ltd. Federal-Mogul Corp.	60 40	Acquired	Tapered roller bearings	1,000	1985
•NTN-Bower Corp.	Macomb, IL	NTN Toyo Bearing Co., Ltd. Federal-Mogul Corp.	60 40	Acquired	Tapered/cylindrical roller bearings		1985
National Steel Corp.	Granite City, IL	Nippon Kokan K.K. National Intergroup Inc.	50 50	Acquired	Steel slabs/hot-rolled, cold-rolled/coated steel sheets	12,000	1984
National Steel Corp.	Portage, IN	Nippon Kokan K.K. National Intergroup Inc.	50 50	Acquired	Cold-rolled, coated/tin-plate steel sheets		1984
National Steel Corp.	Ecorse, MI	Nippon Kokan K.K. National Intergroup Inc.	50 50	Acquired	Steel slabs/hot-rolled, cold-rolled/galvanized steel sheets		1984
Neaton Auto Products Manufacturing Inc.	Eaton, OH	Nihon Plast Co., Ltd.	100	New	Automotive steering wheels	100	1985
Neptune Packing Corp.	Mayaquez, PR	Mitsui & Co., Ltd.	100	Acquired	Canned fish	550	1974
•New Hampshire Ball Bearings Inc.	Jaffrey, NH	Minebea Co., Ltd.	100	Acquired	Ball bearings	200	1985
•New Hampshire Ball Bearings Inc.	Jaffrey, NH	Minebea Co., Ltd.	100	New	Prototype bearings	50*	1986*
•New Hampshire Ball Bearings Inc., Astro Division	Laconia, NH	Minebea Co., Ltd.	100	Acquired	Rod-end bearings	400	1985
•New Hampshire Ball Bearings Inc., Scotia Division	Laconia, NH	Minebea Co., Ltd.	100	Acquired	Component parts	100	1985
•New Hampshire Ball Bearings Inc.	Peterborough, NH	Minebea Co., Ltd.	100	Acquired	Ball bearings	1,200	1985
New United Motor Manufacturing Inc.	Fremont, CA	Toyota Motor Corp. General Motors Corp.	50 50	New	Cars, automotive body stampings	2,500	1984
Nichimo Northwest, Inc.	Everson, WA	Nichimo Co., Ltd. Northwest Net & Twine, Inc.	70 30	New	Gill nets	20	1982
Nidec Torin Corp.	Torrington, CT	Nippon Densan Corp.	100	Acquired	Small horsepower fans for computer motors	200	1984
Nidek Inc.	Palo Alto, CA	Nidek Co., Ltd.	100	New	Auto-refractometers, photocoagulators/other ophthalmologic instruments	4	1983
Niitakaya USA Inc.	Los Angeles, CA	Niitakaya Co., Ltd.	100	Acquired	Pickles	10	1983
Nikko Wolverine Inc.	Dearborn Heights, MI	Nippon Mining Co., Ltd. C. Itoh & Co., Ltd. UOP Inc.	51 29 20	Acquired	Titanium/zirconium tubes/pipe	60	1981
Nintendo of America, Inc.	Seattle, WA	Nintendo Co., Ltd.	100	New	Video game machines	50	1982
Nippondenso Manufacturing U.S.A. Inc.	Battle Creek, MI	Nippondenso Co., Ltd.	100	New	Automotive windshield washers/heaters	55	1983
•Nippondenso Manufacturing U.S.A. Inc.	Battle Creek, MI	Nippondenso Co., Ltd.	100	New	Heat exchangers, evaporators/condensers for automotive air conditioners	400*	1986*
Nisco Steel Services Inc.	Memphis, TN	Nissho Iwai Corp.	100	New	Steel processing	46	1984
Nisshin Gulf Coast Inc.	Houston, TX	Nisshin Chemical Industry Co., Ltd. EGC Corp.	50 50	New	Custom fluoropolymer linings for corrosion resistance	n.a.	1984

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
Nitto Denko America, Inc.	Santa Clara, CA	Nitto Electric Industrial Co., Ltd.	100	New	Membrane modules for recovery of electro-deposited paint	1	1984
North American Brine Resources	Kingfisher County, OK (three sites)	United Resources Industry Co., Ltd.	50	New	Iodine	3	1982
		Mitsui & Co., Ltd.	10				
		Beard Oil Co.	40				
North American Lighting, Inc.	Flora, IL	Koito Manufacturing Co., Ltd.	39	New	Automotive lighting equipment	33	1983
		Ichikoh Industries Ltd.	10				
		Westfalische Metal Industrie AG	51				
North Pacific Processors Inc.	Cordova, AK	Marubeni Corp.	100	New	Canned/frozen fish	450	1972
North Pacific Processors Inc.	Kenai, AK	Marubeni Corp.	100	New	Canned/frozen fish		1972
North Pacific Processors Inc.	Kodiak, AK	Marubeni Corp.	100	New	Canned/frozen fish		1972
●Nova Steel Processing Inc.	Tipp City, OH	C. Itoh & Co., Ltd.	50	New	Steel processing	40*	1986*
		Armco Inc.	50				
Nutrius Inc.	Van Buren, AR	Mitsui & Co., Ltd.	100	Acquired	Feed additives	150	1981
Nutrius Inc.	Cypress, CA	Mitsui & Co., Ltd.	100	Acquired	Feed additives		1984
Nutrius Inc.	Fresno, CA	Mitsui & Co., Ltd.	100	Acquired	Feed additives		1981
Nutrius Inc.	Kingsburg, CA	Mitsui & Co., Ltd.	100	Acquired	Feed additives		1984
Nutrius Inc.	Manson, IA	Mitsui & Co., Ltd.	100	Acquired	Feed additives		1983
Nutrius Inc.	Louisville, KY	Mitsui & Co., Ltd.	100	Acquired	Feed additives		1981
Oak-Mitsui, Inc.	Hoosick Falls, NY	Mitsui Mining & Smelting Co., Ltd.	20	New	Electro-deposited copper foil	165	1976
		Oak Industries Inc.	80				
●Ogihara America Corp.	Howell, MI	Ogihara Iron Works Co., Ltd.	100	New	Automotive parts stampings	100*	1986*
Okabashi (U.S.) Corp.	Buford, GA	Okabashi Co., Ltd.	Minority share	New	Men's/women's sandals/other footwear	20	1982
Oki America Inc.	Norcross, GA	Oki Electric Industry Co., Ltd.	100	New	Electronic private branch exchanges, cellular mobile communications equipment	150	1984
Oki Semiconductor Inc.	Sunnyvale, CA	Oki Electric Industry Co., Ltd.	100	New	Integrated circuits	30	1984
Olympic Wood Products Inc.	Shelton, WA	Takeuchi Lumber Co., Ltd.	50	New	Lumber	15	1982
		Kanda Corp.	40				
		Aika Kogyo Co., Ltd.	10				
Omega Tube and Conduit Corp.	Little Rock, AR	Sumitomo Metal Industries, Ltd.	80	New	Welded steel tubing	150	1985
		Sumitomo Corp.	10				
		Quality Metals Inc.	10				
Orange Bakery Inc.	Irvine, CA	Rheon Automatic Machinery Co., Ltd.	100	New	Bakery products	50	1979
Orange Bakery Inc.	Irvine, CA	Rheon Automatic Machinery Co., Ltd.	100	New	Bakery products	15	1985
Orient Shimazaki Chemical Corp.	Newark, NJ	Shimazaki Corp.	n.a.	New	Nigrosine (black dye)	n.a.	1981
		Orient Chemical Industries Co., Ltd.	n.a.				

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
•Oxford Wire & Cable Services Inc.	Oxford, MS	Hayakawa Densen Kogyo Co., Ltd. Hitachi Cable, Ltd.	70 30	New	Wire harnesses for appliances	40	1986
•PMP Fermentation Products Inc.	Peoria, IL	Fujisawa Pharmaceutical Co., Ltd.	100	Acquired	Industrial detergents, enzymes	21	1985
Pacific Propeller, Inc.	Kent, WA	Minebea Co., Ltd.	100	Acquired	Aircraft propellers	80	1982
Pasco Corp. of America	Torrance, CA	Shikishima Baking Co., Ltd. Nissho Iwai Corp.	85 15	New	Bakery products	28	1984
Pearl International Corp.	Nashville, TN	Pearl Musical Instrument Co.	100	New	Musical drums	45	1979
•Pentax Ophthalmic Inc.	Minnetonka, MN	Asahi Optical Co., Ltd.	100	New	Coating of eyeglass lenses	25*	1986*
Peter Pan Seafoods Inc.	Dillingham, AK	Nichiro Gyogyo Kaisha, Ltd.	100	Acquired	Canned fish	90	1979
Peter Pan Seafoods Inc.	King Cove, AK	Nichiro Gyogyo Kaisha, Ltd.	100	Acquired	Canned/frozen fish	290	1979
Peter Pan Seafoods Inc.	Port Moller, AK	Nichiro Gyogyo Kaisha, Ltd.	100	Acquired	Frozen fish	120	1979
•Pioneer Industrial Components Inc.	Springboro, OH	Pioneer Electronic Corp.	100	New	Automotive audio equipment	200*	1986*
Pioneer Video Manufacturing Inc.	Carson, CA	Pioneer Electronic Corp.	100	Acquired	Video discs	180	1982
•Polychrome Corp.	Chicago, IL	Dainippon Ink & Chemicals, Inc.	100	New	Specialty resins	n.a.	1986
•Powerex, Inc.	Auburn, NY	Mitsubishi Electric Corp. General Electric Co. Westinghouse Electric Corp.	10 45 45	Acquired	Discrete devices	300	1985
•Powerex, Inc.	Youngwood, PA	Mitsubishi Electric Corp. General Electric Co. Westinghouse Electric Corp.	10 45 45	Acquired	Discrete devices	350	1985
•Powerex, Inc.	Gurabo, PR	Mitsubishi Electric Co. General Electric Co. Westinghouse Electric Corp.	10 45 45	Acquired	Discrete devices	200	1985
Pyr Coat Inc.	Houston, TX	Mitsui & Co., Ltd.	60	Acquired	Fireproof coatings, fireproof insulation/adhesives, asbestos encapsulation/removal products	5	1983
Q & B Foods, Inc.	Baldwin Park, CA	Q.P. Corp. Nakashima-to Co., Ltd.	96 4	New	Salad dressings, mayonnaise	16	1982
Rakuyo Ken U.S.A Inc.	Honolulu, HI	Rakuyo Shokuhin Co., Ltd.	100	New	Shumai	8	1981
Rion Acoustic Instruments, Inc.	Torrance, CA	Rion Co., Ltd.	100	New	Custom-designed hearing aids	3	1984
S & B International Corp.	Torrance, CA	S & B Shokuhin Co., Ltd.	100	New	Seasoning mixes	4	1975
SMK Manufacturing Inc.	Placentia, CA	SMK Corp.	100	Acquired	Computer keyboards	60	1981
San-O Industrial Corp.	Bohemia, NY	San-O Industrial Co., Ltd.	100	New	Electronic fuses, fuse holders, fuse blocks, terminals/related equipment	70	1981
Sanoh Manufacturing Corp.	San Diego, CA	Sanoh Industrial Co., Ltd. Sanyo Electric Co., Ltd.	80 20	New	Refrigerator parts	27	1981
Scripto Tokai Inc.	Doraville, GA	Tokai Seiki Co., Ltd.	100	Acquired	Writing instruments	325	1984
•SeaBlends Food Co. Inc.	Seattle, WA	Nichiro Gyogyo Kaisha, Ltd.	100	New	Frozen imitation crab products	25*	1986*
•Shachihata Inc. (U.S.A.)	Lakewood, NJ	Shachihata Industrial Co., Ltd.	100	New	Pre-inked rubber stamps	35	1985

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
•Sheller-Ryobi Corp.	Shelbyville, IN	Ryobi Ltd. Sheller-Globe Corp.	55 45	New	Aluminum transmission casings/ other die-cast aluminum automotive products	100*	1986*
Shindo International, Inc.	New York, NY	Shindo Shashin Seikan K.K.	100	New	Color separation, offset printing	n.a.	1978
Shinko Electric America Inc.	Manteca, CA	Shinko Electric Co., Ltd.	100	New	Lead frames for integrated circuits	34	1983
Sierracin Glass Transparencies Inc.	Sylmar, CA	Asahi Glass Co., Ltd. Sierracin Corp.	50 50	New	Glass transparencies for aircraft	50	1982
Sony Magnetic Products Inc.	Laredo, TX	Sony Corp.	100	New	Audio cassette tapes	50	1979
Sony Professional Products Co.	Fort Lauderdale, FL	Sony Corp.	100	Acquired	Audio/video professional equipment	300	1982
Stanley Electric U.S. Co., Inc.	London, OH	Stanley Electric Co., Ltd.	100	New	Automotive/motorcycle lighting equipment	60	1982
•Stauffer-Meiji, Inc.	York, PA	Meiji Seika Kaisha, Ltd. D.F. Stauffer Biscuit Co., Inc.	75 25	New	Chocolate candy/cookies	50*	1986*
•Sumitec Inc.	Benton Harbor, MI	Sumitomo Metal Industries, Ltd. Satosen Co., Ltd. Osaka Fuji Kogyo Co., Ltd. Electro-Coatings Inc.	50 5 5 40	New	Coating/repair of continuous steel casting molds	30	1985
Sumitomo Electric Research Triangle, Inc.	Research Triangle, NC	Sumitomo Electric Industries, Ltd.	100	New	Fiber-optic cables	320	1985
Sumitomo Metal Mining California Corp.	Fremont, CA	Sumitomo Metal Mining Co., Ltd.	100	New	Lead frames for integrated circuits	70	1985
Systems Magnetic Co.	Anaheim, CA	Hitachi Metals, Ltd.	100	Acquired	Voice coil motors for computer disk drives	210	1984
TNS Mills, Inc.	Eufaula, AL	Tsuzuki Spinning Co., Ltd.	100	Acquired	Cotton yarn	150	1985
TNS Mills, Inc.	Spartanburg, SC	Tsuzuki Spinning Co., Ltd.	100	New	Cotton-blend sheeting, polyester-cotton blend yarn	170	1982
TYK Swank Refractories Co.	Irvona, PA	Tokyo Yogyo Co., Ltd.	100	Acquired	Steel industry refractory products	30	1982
Taiyo Yuden (USA), Inc.	San Marcos, CA	Taiyo Yuden Co., Ltd.	100	New	Axial capacitors	40	1981
Takane USA, Inc.	Torrance, CA	Takane Sogyo Co., Ltd. Takane Co., Ltd. Ikeda Bussan Kaisha, Ltd. Micro Engineering Co., Ltd.	28 22 18 6	New	Quartz clock movements	55	1980
Takasago Corp. USA	Teterboro, NJ	Takasago Perfumery Co., Ltd.	100	Acquired	Food flavoring compounds	35	1984
Takeda Chemical Products U.S.A. Inc.	Wilmington, NC	Takeda Chemical Industries, Ltd.	100	New	Vitamin B_1	20	1985
•Teikoku Corp.	Hayward, CA	Teikoku Chromium Plating Co., Ltd.	100	New	Plating/repair of press molds	12	1986
Templock/AFM Inc.	Carpinteria, CA	Nippon Automatic Fine Machinery Co., Ltd. Marubun Corp. Templock Corp.	39 10 51	New	Heat-shrinkable plastic material application machinery	n.a.	1981
•Thermalex Inc.	Montgomery, AL	Mitsubishi Aluminum Co., Ltd. Thermal Components Inc.	50 50	New	Aluminum extrusions for heat-exchanger applications	30*	1986*
Thin Film Technology Corp.	North Mankato, MN	Susumu Co., Ltd.	100	New	Thin-film resistive electronic components	50	1982

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
•Thinsheet Metals Co.	Tempe, AZ	Nisshin Steel Co., Ltd.	96	Acquired	Copper, nickel/steel processing	90	1985
•Thinsheet Metals Co.	Waterbury, CT	Nisshin Steel Co., Ltd.	96	Acquired	Thin-gauge copper/nickel alloy, brass/stainless steel sheets		1985
Togiak Fisheries, Inc.	Togiak, AK	Marubeni Corp.	100	Acquired	Canned/frozen fish	140	1972
Tokai of America Inc.	Rancho Cucamonga, CA	Tokai Seiki Co., Ltd.	100	New	Disposable cigarette lighters	40	1982
Tomoegawa (U.S.A.) Inc.	Wheeling, IL	Tomoegawa Paper Co., Ltd.	100	New	Toner/developer/other consummable supplies for photocopying industry	50	1980
•Topy Corp.	Frankfort, KY	Topy Industries, Ltd.	100	New	Steel automotive wheels	80*	1986*
•Toshiba America, Inc.	Irvine, CA	Toshiba Corp.	100	New	Telecommunications equipment, medical electronics equipment	500*	1986*
•Toshiba Westinghouse Electronics Corp.	Horseheads, NY	Toshiba Corp. Westinghouse Electric Corp.	50 50	New	Cathode ray tubes	325*	1986*
Totaku America Corp.	Compton, CA	Totaku Industries Inc.	100	New	Plastic/rubber flexible hose	50	1974
Toyojamco, Ltd.	York, PA	Japan Automatic Machine Co., Ltd. Oriental Terminal Products Co., Ltd.	50 50	New	Components for automatic crimping machinery	15	1983
•Trans-Ocean Products, Inc.	Bellingham, WA	Taiyo Fishery Co., Ltd. Steuart Investment Co.	50 50	New	Frozen imitation crab products	50	1985
•Trea Industries Inc.	North Kingston, RI	Toray Industries, Inc.	100	Acquired	Polypropylene film	55	1985
Tri-Con Industries, Ltd.	Cape Girardeau, MO	Tokyo Seat Co., Ltd.	100	New	Automotive seats	470	1983
Tri-Con Industries, Ltd.	Columbia, MO	Tokyo Seat Co., Ltd.	100	New	Automotive seats	250	1983
Tri-Con Industries, Ltd.	Lincoln, NE	Tokyo Seat Co., Ltd.	100	New	Automotive seat frames	30	1985
Tube Turns Inc.	Louisville, KY	Sumitomo Metal Industries, Ltd. Sumitomo Corp. Sumitomo Bank, Ltd.	49 49 2	Acquired	Welded steel fittings, forgings, engineered products	300	1983
UGM, Inc.	Santa Clara, CA	Tokyo Tan-Ichi Co., Ltd.	100	New	Metal stampings for integrated circuit lead frames	9	1976
•U.S. Felt Co.	Augusta, GA	Hosokawa Micron Corp. Edward J. Andrew Ltd.	51 49	Acquired	Felt for dust collector filters	24	1985
U.S. Fuji Electric Inc.	Piscataway, NJ	Fuji Electric Co., Ltd.	100	New	Photo-sensitive drums for copiers	30	1983
US JVC Corp.	Elmwood Park, NJ	Victor Co. of Japan, Ltd.	100	New	Color television sets	45	1982
USR Optinix Inc.	Hackettstown, NJ	Mitsubishi Chemical Industries, Ltd.	100	Acquired	Fluorescent material for cathode ray tube displays	50	1981
Union Inc.	Costa Mesa, CA	Union Trade Co., Inc.	100	New	Instant noodles	120	1976
Universal Magnetics, Inc.	Chatsworth, CA	Minebea Co., Ltd.	100	Acquired	Direct-current motors for computer equipment	100	1984
Universal Seafoods Ltd.	Dutch Harbor, AK	Nippon Suisan Kaisha, Ltd.	99	New	Frozen fish	100	1975
Universal Seafoods Ltd.	Redmond, WA	Nippon Suisan Kaisha, Ltd.	99	New	Frozen fish, frozen imitation crab products	200	1975
VAM-PTS Co.	Houston, TX	Sumitomo Metal Industries, Ltd. Sumitomo Corp. Vallourec S.A.	49 51	Acquired	Steel threading for oil/gas drilling pipe	130	1984
Viam Manufacturing Inc.	Santa Fe Springs, CA	Japan Vilene Co., Ltd. Dainippon Ink & Chemicals Inc.	60 40	New	Automotive floor mats	50	1984
•Vicksmetal Corp.	Vicksburg, MS	Sumitomo Corp.	100	New	Steel processing	20	1985

Company	Plant Location	Parent	Share	New or Acquired	Product Line	Employees	Year Plant Opened or Acquired
Wacoal America Inc.	Luquio, PR	Wacoal Corp.	100	Acquired	Women's intimate apparel	785	1983
Wards Cove Packing Co., Inc.	Alitak, AK	Marubeni Corp.	Minority share	Acquired	Canned/frozen fish	1,500	1973
Wards Cove Packing Co., Inc.	Ekuk, AK	Marubeni Corp.	Minority share	Acquired	Canned/frozen fish		1973
Wards Cove Packing Co., Inc.	Excursion Inlet, AK	Marubeni Corp.	Minority share	Acquired	Canned/frozen fish		1973
Wards Cove Packing Co., Inc.	Icy Cape, AK	Marubeni Corp.	Minority share	Acquired	Canned/frozen fish		1973
Wards Cove Packing Co., Inc.	Kenai, AK	Marubeni Corp.	Minority share	Acquired	Canned/frozen fish		1973
Wards Cove Packing Co., Inc.	Ketchikan, AK	Marubeni Corp.	Minority share	Acquired	Canned fish		1973
Wards Cove Packing Co., Inc.	Naknek, AK	Marubeni Corp.	Minority share	Acquired	Canned/frozen fish		1973
Wards Cove Packing Co., Inc.	Port Bailey, AK	Marubeni Corp.	Minority share	Acquired	Canned/frozen fish		1973
Warner-Ishi Corp.	Shelbyville, IL	Ishikawajima-Harima Heavy Industries Co., Ltd. Borg-Warner Corp.	50 50	New	Automotive turbochargers	30	1986
Western Alaska Fisheries, Inc.	Kodiak, AK	Taiyo Fishery Co., Ltd.	100	New	Canned/frozen fish	25	1963
Woodward Iodine Corp.	Woodward, OK	Ise Chemical Industries Co., Ltd. Asahi Glass Co., Ltd.	80 20	Acquired	Iodine	18	1984
Wynn-Kiki Inc.	Fort Worth, TX	Diesel Kiki Co., Ltd. Wynn Industries, Inc.	50 50	Acquired	Compressors/evaporators for automotive air conditioners	90	1984
•YKC-Yamada Industries Inc.	Reno, NV	YKC Co., Ltd. Yamada Seisakusho Co., Ltd.	50 50	New	Semiconductor assembly equipment	50*	1986*

n.a. not available
* Projected
• Previously unlisted plants that went into operation during 1985 or were under construction on December 31, 1985, as well as acquisitions that were finalized in 1985.

Appendix 2: U.S. Manufacturing Affiliates of Japanese Companies by State

Alabama
CoilPlus, Inc.
●IB Chemical Co.
Metco America Inc.
●NTN Bower Corp.
TNS Mills, Inc.
●Thermalex Inc.

Alaska
Bering Sea Fisheries, Inc.
Dutch Harbor Seafoods Co., Inc.
●Great Land Seafoods Inc.
North Pacific Processors Inc. (3)
Peter Pan Seafoods Inc. (3)
Togiak Fisheries, Inc.
Universal Seafoods Ltd.
Wards Cove Packing Co., Inc. (8)
Western Alaska Fisheries, Inc.

Arizona
Chickasha Cotton Oil Co.
●Great Western Silicon Corp.
NKK Switches of America, Inc.
●Thinsheet Metals Co.

Arkansas
Alumax Inc., Home and Specialty Products Group
Alumax Inc., Kawneer Co., Inc.
Nutrius Inc.
Omega Tube and Conduit Corp.

California
●AMTEX Inc.
●Airin Inc.
●Alerco and Hayward Steel, Inc. (2)
Alloy Tool Steel Inc.
Alpine Electronics of America, Inc.
●Alps Electric (U.S.A.), Inc.
Alumax Inc., Alumax Fabricated Products, Inc. (2)
Alumax Inc., Home and Specialty Products Group (4)
American Foods Corp. (3)
Amsnack, Inc.
●Atari Games Corp.
●C&M Fine Pack Inc.
California Steel Industries Inc.
Chateau St. Jean
Concise Casting Corp.
Cryodynamics Co.-Ebara Group
Curtis-Maruyasu America, Inc.
Dainippon Screen Engineering of America Inc.
Daiwa Golf Co.
●Electro-Plasma, Inc.
Hirose Electric (U.S.A.), Inc.
Hitachi Consumer Products of America Inc.
Hi-Tek Corp.
House Foods and Yamauchi Inc.
IDEC Systems & Controls Corp.
IKS American Corp.
International Leadframe Corp.
International Light Metals Corp.
Kaga USA Inc.
Kato Spring Inc.
Kikusui International Corp.
●Koltron Corp.
Lafayette Metal Service Corp.
Maruhachi Ceramics of America
Master-Halco, Inc.
Matheson Gas Products Inc. (2)
Megatool Inc.
Memorex DIC Corp.
●Menardi-Southern Corp.
Mitutoyo Corp.
●NBK Corp.
NEC America, Inc.
NEC Electronics U.S.A. Inc.
New United Motor Manufacturing Inc.
Nidek Inc.
Niitakaya USA Inc.
Nitto Denko America, Inc.
Nutrius Inc. (3)
Oki Semiconductor Inc.
Orange Bakery Inc. (2)
Pasco Corp. of America
Pioneer Video Manufacturing Inc.
Q & B Foods, Inc.
Rion Acoustic Instruments, Inc.
S & B International Corp.
SMK Manufacturing Inc.
Sanoh Manufacturing Corp.
Shinko Electric America Inc.
Sierracin Glass Transparencies Inc.
Sumitomo Metal Mining California Corp.
Systems Magnetic Co.
Taiyo Yuden (USA), Inc.
Takane USA, Inc.
●Teikoku Corp.
Templock/APM Inc.
Tokai of America Inc.
●Toshiba America, Inc.
Totaku America Corp.
UGM, Inc.
Union Inc.
Universal Magnetics, Inc.
Viam Manufacturing Inc.

Colorado
Alumax Inc., Kawneer Co., Inc.
Data Ray Corp.

Connecticut
Nidec Torin Corp.
●Thinsheet Metals Co.

Delaware
No listings

Florida
ASTRONET Corp.
Alumax Inc., Home and Specialty Products Group
Fujitsu America, Inc.
●IMC Magnetics Corp.
Sony Professional Products Co.

Georgia
Alumax Inc., Alumax Fabricated Products, Inc. (2)
Alumax Inc., Home and Specialty Products Group (3)
Alumax Inc., Prime Metals Division
Amitech Inc.
High Voltage Breakers, Inc.
Hitachi Chemical Co. America, Ltd.
●Hoshizaki America, Inc.
Kato Spring of Georgia Inc
Kubota Tractor Corp.
●Makita Corp. of America
Matheson Gas Products Inc.
●Menardi-Southern Corp.
●Mitsubishi Consumer Electronics America, Inc.
Mizuno Golf Co.
NEC Home Electronics (U.S.A.) Inc.
Okabashi (U.S.) Corp.
Oki America Inc.
Scripto Tokai Inc.
●U.S. Felt Co.

Hawaii
Bunmeido of Hawaii Ltd.
Daiichiya Love's Bakery Inc.
Honma Golf, Inc.
Rakuyo Ken U.S.A. Inc.

Idaho
No additional listings

Illinois
Alumax Inc., Home and Specialty Products Group
●Diamond-Star Motors Corp.
LyphoMed Inc.
Matheson Gas Products Inc.
Matsushita Communication Co.
●NTN-Bower Corp.
National Steel Corp.
North American Lighting, Inc.
●PMP Fermentation Products Inc.
●Polychrome Corp.
Tomoegawa (U.S.A.) Inc.
Warner-Ishi Corp.

Indiana
Alumax Inc., Alumax Fabricated Products, Inc.
Digital Audio Disc Corp.
●Enkenei America Inc.
National Steel Corp.
●Sheller-Ryobi Corp.

Iowa
Heartland Lysine, Inc.
Nutrius Inc.

Kansas
No additional listings

Kentucky
ATR Wire and Cable Co.
Alumax Inc., Alumax Aluminum Corp.
●Hitachi Automotive Products (USA) Inc.
●Isuzu Truck of America Inc.
●C. Itoh Steel Inc.
Nutrius Inc.
●Topy Corp.
Tube Turns Inc.

Louisiana
●Kentwood Spring Water Inc.
Matheson Gas Products Inc.

Maine
No additional listings

Maryland
No additional listings

Massachusetts
Kameyama U.S.A. Inc.
Matheson Gas Products Inc.
NEC Information Systems, Inc.

Michigan
Alumax Inc., Prime Metals Division (2)
●American Yazaki Corp.
Cast Forge Co.
FEC Inc.
●GMF Robotics Corp.
Hemlock Semiconductor Corp.
●Kux Manufacturing Co.
●Mazda Motor Manufacturing (USA) Corp.
Musashi USA Inc.
National Steel Corp.
Nikko Wolverine Inc.
●Nippondenso Manufacturing U.S.A. Inc. (2)
●Ogihara America Corp.
●Sumitec Inc.

Minnesota
●Pentax Ophthalmic Inc.
Thin Film Technology Corp.

Mississippi
●Oxford Wire & Cable Services Inc.
●Vicksmetal Corp.

Missouri
Alumax Inc., Home and Specialty Products Group
Alumax Inc., Prime Metals Division
Bio Kyowa Inc.
Kel-Am, Inc.
Tri-Con Industries, Ltd. (2)

Montana
No listings

Nebraska
Diamond Plastics Corp.
Tri-Con Industries, Ltd.

Nevada
●YKC-Yamada Industries Inc.

New Hampshire
Coca-Cola Bottling Co.
●New Hampshire Ball Bearings Inc. (5)

New Jersey
●American Fuji Seal, Inc.
●Hishi Plastics U.S.A., Inc.
Iwatsu America Inc.
MCI Optinix Inc.
Matheson Gas Products Inc.
●Mikropul Corp.
NSG America Inc.
Orient Shimazaki Chemical Corp.
●Shachihata Inc. (U.S.A.)
Takasago Corp. USA
U.S. Fuji Electric Inc.
US JVC Corp.
USR Optinix Inc.

New Mexico
No listings

New York
●Aderans & Alfieri Inc.
●K.N. Aronson Inc.
Economic Salon, Ltd.
●Kawasaki and Nissho Iwai Partnership
Oak-Mitsui, Inc.
●Powerex, Inc.
San-O Industrial Corp.
Shindo International, Inc.
●Toshiba Westinghouse Electronics Corp.

North Carolina
Alumax Inc., Alumax Extrusions, Inc.
●Alumax Inc., Kawneer Co., Inc.
Fuji Cone Inc.
Fuji Foods Inc.
Honda Power Equipment Manufacturing Inc.
Kibun Corp. of North Carolina
Mitsubishi Semiconductor America Inc.
Sumitomo Electric Research Triangle, Inc.
Takeda Chemical Products U.S.A. Inc.

North Dakota
No listings

Ohio
●AP Technoglass Corp.
Alumax Inc., Prime Metals Division
Ando Screen Inc.
●Barudan America Inc.
Bellemar Parts Industries Inc. (2)
●Belletech Corp.
●Berwick Steel Co.
●Bleim Steel Co.
Fujitec Industries, Inc.
Honda of America Manufacturing, Inc.
KTH Parts Industries Inc.
●L-S Electro-Galvanizing Co.
LeBlond Makino Machine Tool Co.
Matheson Gas Products Inc.
Neaton Auto Products Manufacturing Inc.
●Nova Steel Processing Inc.
●Pioneer Industrial Components Inc.
Stanley Electric U.S. Co., Inc.

Oklahoma
Chickasha Cotton Oil Co.
●Hitachi Computer Products (America) Inc.
North American Brine Resources
Woodward Iodine Corp.

Oregon
Enway Inc.
●Epson Portland Inc.
●Fujitsu America, Inc.
NEC America, Inc.

Pennsylvania
Alumax Inc., Alumax Aluminum Corp.
Alumax Inc., Alumax Fabricated Products, Inc.
Alumax Inc., Home and Specialty Products Group (3)
●Powerex, Inc.
●Stauffer-Meiji, Inc.
TYK Swank Refractories Co.
Toyojamco Ltd.

Rhode Island
Machine Specialties Co.
●Trea Industries Inc.

South Carolina
●Alcoa Conductor Accessories Inc.
●Alcoa Fujikura Ltd.
TNS Mills, Inc.

South Dakota
No additional listings

Tennessee
Bridgestone (USA) Inc.
●CKR Industries, Inc.
Calsonic Manufacturing Corp.
Clarion Corp. of America
Kantus Corp.
●Komatsu America Manufacturing Corp.
Nisco Steel Services Inc.
Pearl International Corp.

Texas
Alloy Tool Steel of Texas Inc.
Alumax Inc., Alumax Extrusions, Inc. (2)
Alumax Inc., Alumax Fabricated Products, Inc.
Alumax Inc., Alumax Mill Products, Inc. (2)
Alumax Inc., Home and Specialty Products Group (3)
Alumax Inc., Kawneer Co., Inc.
Alumax Inc., Prime Metals Division
Chickasha Cotton Oil Co. (2)
Diamond Plastics Corp.
●EVAL Co. of America
First Metals, Inc.
Fuji Koki America Inc.
Fujitsu America, Inc.
Kaneka Texas Corp.
Master-Halco, Inc.
Matheson Gas Products Inc.
●Menardi-Southern Corp.
●Mori Seiki U.S.A. Inc.
Nisshin Gulf Coast Inc.
Pyr Coat Inc.
Sony Magnetic Products Inc.
VAM-PTS Co.
Wynn-Kiki Inc.

Utah
No listings

Vermont
No additional listings

Virginia
Amano-International Enzyme Co., Inc.
●Canon Virginia Inc.

Washington
Alpha Biochemical Corp.
International Titanium Inc.
Japan Aircraft Maintenance (America), Inc.
●Kawasaki Thermal Systems, Inc.
Kibun Corp. of Washington
Kyocera Northwest Inc.
Nichimo Northwest, Inc.
Nintendo of America, Inc.
Olympic Wood Products Inc.
Pacific Propeller, Inc.
●SeaBlends Food Co. Inc.
●Trans-Ocean Products Inc.
Universal Seafoods Ltd.

West Virginia
No listings

Wisconsin
No additional listings

Wyoming
No listings

Puerto Rico
Matsushita Electric of Puerto Rico, Inc.
Mitsubishi Foods Inc.
Neptune Packing Corp.
●Powerex, Inc.
Wacoal America Inc.

●Previously unlisted plants that went into operation during 1985 or were under construction on December 31, 1985, as well as acquisitions that were finalized in 1985.

Note: A number in parentheses indicates that the relevant company has plants in more than one location in the state.

Appendix 3: U.S. Manufacturing Affiliates of Japanese Companies by Product Line

Food Products

2013	Shumai	Rakuyo Ken U.S.A. Inc.
2034	Instant noodles	Union Inc.
2035	Cooking wines	American Foods Corp.
	Sauces	American Foods Corp.
	Salad dressings, mayonnaise	Q & B Foods, Inc.
	Pickles	Niitakaya USA Inc.
2037	Frozen potato products	Enway Inc.
2051	Bakery products	Bunmeido of Hawaii Ltd.
	Bakery products	Daiichiya Love's Bakery Inc.
	Bakery products	Orange Bakery Inc (2)
	Bakery products	Pasco Corp. of America
2052	Rice crackers	●Airin Inc.
	Rice crackers	Amsnack, Inc.
	Cookies	●Stauffer-Meiji, Inc.
2065	Chocolate candy	●Stauffer-Meiji, Inc.
2074	Cottonseed oil	Chickasha Cotton Oil Co. (4)
2077	Binder for fish feed	Alpha Biochemical Corp.
2084	Wine	Chateau St. Jean
2086	Soft drinks	Coca-Cola Bottling Co.
	Bottled water	●Kenwood Spring Water Inc.
2091	Canned fish	Mitsubishi Foods Inc.
	Canned fish	Neptune Packing Corp.
	Canned fish	North Pacific Processors Inc. (3)
	Canned fish	Peter Pan Seafoods Inc. (2)
	Canned fish	Togiak Fisheries, Inc.
	Canned fish	Wards Cove Packing Co., Inc. (8)
	Canned fish	Western Alaska Fisheries, Inc.
2092	Frozen fish	Bering Sea Fisheries, Inc.
	Frozen fish	Dutch Harbor Seafoods Co., Inc.
	Frozen fish	North Pacific Processors Inc. (3)
	Frozen fish	Peter Pan Seafoods Inc. (2)
	Frozen fish	Togiak Fisheries, Inc.
	Frozen fish	Universal Seafoods Ltd. (2)
	Frozen fish	Wards Cove Packing Co., Inc. (7)
	Frozen fish	Western Alaska Fisheries, Inc.
	Surimi (boiled fish paste)	●Great Land Seafoods Inc.
	Frozen imitation crab products	Kibun Corp. of North Carolina
	Frozen imitation crab products	Kibun Corp. of Washington
	Frozen imitation crab products	●SeaBlends Food Co., Inc.
	Frozen imitation crab products	●Trans-Ocean Products Inc.
	Frozen imitation crab products	Universal Seafoods Ltd.
2099	Beef/chicken extracts for soup stocks	Fuji Foods Inc.
	Tofu/related soybean products	House Foods and Yamauchi Inc.
	Seasoning mixes	S & B International Corp.
	Vinegar	American Foods Corp. (3)

Tobacco Manufactures

No listings

Textile Mill Products

2211	Cotton-blend sheeting	TNS Mills, Inc.
	Filter cloths	●Menardi-Southern Corp. (3)
2271	Automotive floor mats	●AMTEX Inc.
	Automotive floor mats	Viam Manufacturing Inc.
2281	Cotton yarn	TNS Mills, Inc.
	Polyester-cotton blend yarn	TNS Mills, Inc.
2291	Felt for dust collector filters	●U.S. Felt Co.
2297	Fabric filter media for pollution control, product recovery, straining/separation	●Menardi-Southern Corp. (3)

Apparel and Made-up Textile Products

234	Women's intimate apparel	Wacoal America Inc.
2393	Filter bags	●Menardi-Southern Corp. (3)
2399	Gill nets	Nichimo Northwest, Inc.

Lumber and Wood Products

2421	Lumber	Olympic Wood Products Inc.

Furniture and Fixtures

2517	Speaker boxes	Matsushita Electric of Puerto Rico, Inc.

Paper and Paper Products

No additional listings

Printing and Publishing

2721	Periodicals publishing	Economic Salon, Ltd.
2751	Self-adhesive lettering/decals for motor vehicles/industrial equipment	●Kux Manufacturing Co.
2752	Color separation, offset printing	Shindo International, Ltd.

Chemicals and Related Products

2813	Specialty gases	Matheson Gas Products Inc. (9)
2819	Fluorescent material for cathode ray tube displays	USR Optinix Inc.
	Iodine	North American Brine Resources
	Iodine	Woodward Iodine Corp.
2821	Ethylene vinyl alcohol copolymer resins	●EVAL Co. of America
	Methyl methacrylate-butadiene-styrene resins	Kaneka Texas Corp.
	Specialty resins	●Polychrome Corp.
2833	Vitamin B_1	Takeda Chemical Products U.S.A. Inc.
2834	Injectable drugs	LyphoMed Inc.
2841	Industrial detergents	●PMP Fermentation Products Inc.
2865	Nigrosine (black ink)	Orient Shimazaki Chemical Corp.
2869	Enzymes	Amano-International Enzyme Co., Ltd.
	Enzymes	●PMP Fermentation Products Inc.
	Food flavoring compounds	Takasago Corp. USA
	Feed additives	Nutrius Inc. (6)
	Lysine (feedstuff amino acid additive)	Bio Kyowa Inc.

	Lysine (feedstuff amino acid additive)	Heartland Lysine Inc.
	Impact modifiers for plastics industry	Metco America Inc.
2873	Slow-release nitrogen fertilizers	●IB Chemical Co.
2899	Fireproof coatings, fireproof spray insulation/adhesives, asbestos encapsulation/removal products	Pyr Coat Inc.

Petroleum Refining

No additional listings

Rubber and Miscellaneous Plastic Products

3011	Radial truck/bus tires	Bridgestone (USA) Inc.
3041	Plastic/rubber flexible hose	Totaku America Corp.
3069	Pre-inked rubber stamps	●Shachihata Inc. (U.S.A.)
3079	Polyvinyl chloride pipes	Diamond Plastics Corp. (2)
	Polyvinyl chloride heat-shrinkable tubing	●Hishi Plastics U.S.A., Inc.
	Polypropylene film	●Trea Industries Inc.
	Custom fluoropolymer linings for corrosion resistance	Nisshin Gulf Coast Inc.
	Plastic containers	●C&M Fine Pack Inc.
	Plastic parts for electronics industry/medical uses	Amitech Inc.
	Heat-shrink labels	●American Fuji Seal, Inc.

Leather and Leather Products

314	Men's/women's sandals/other footwear	Okabashi (U.S.) Corp.

Stone, Clay, Glass and Concrete Products

3211	Automotive safety glass	●AP Technoglass Corp.
3231	Glass transparencies for aircraft	Sierracin Glass Transparencies Inc.
3259	Roofing tiles	Maruhachi Ceramics of America
3297	Steel industry refractory products	TYK Swank Refractories Co.

Primary Metals

3312	Hot-rolled, cold-rolled/galvanized steel sheets/coils, hot-rolled steel plates	California Steel Industries Inc.
	Steel slabs/hot-rolled, cold-rolled/coated steel sheets	National Steel Corp.
	Cold-rolled, coated/tin-plate sheets	National Steel Corp.
	Steel slabs/hot-rolled, cold-rolled/galvanized steel sheets	National Steel Corp.
	Galvanized steel sheets	●L-S Electro-Galvanizing Co.
3315	Thin-gauge stainless steel sheets	●Thinsheet Metals Co.
3317	Welded steel tubing	Omega Tube and Conduit Corp.
	Insulated oilfield pipe	●Kawasaki Thermal Systems, Inc.
3339	Titanium sponge	International Titanium Inc.
	Polycrystalline silicon	●Great Western Silicon Corp.
	Polycrystalline silicon	Hemlock Semiconductor Corp.
3341	Secondary aluminum billet	Alumax Inc., Alumax Extrusions, Inc.
	Recycled aluminum scrap	Alumax Inc., Alumax Mill Products, Inc.
3351	Thin-gauge copper, nickel alloy/brass sheets	●Thinsheet Metals Co.
3353	Aluminum container sheet	Alumax Inc., Alumax Mill Products, Inc.
	Aluminum sheet	Alumax Inc., Alumax Aluminum Corp. (2)
3354	Aluminum extruded shapes	Alumax Inc., Alumax Extrusions, Inc. (2)
	Aluminum bars/extrusions	International Light Metals Corp.
	Aluminum extrusions for heat-exchanger applications	●Thermalex Inc.
3356	Titanium bars/extrusions	International Light Metals Corp.
	Titanium/zirconium tubes/pipe	Nikko Wolverine Inc.
3361	Aluminum castings	Concise Casting Corp.

Fabricated Metal Products

344	Steel processing	Alloy Tool Steel Inc.
	Steel processing	Alloy Tool Steel of Texas Inc.
	Steel processing	●Berwick Steel Co.
	Steel processing	●Bleim Steel Co.
	Steel processing	CoilPlus, Inc.
	Steel processing	First Metals, Inc.
	Steel processing	●C. Itoh Steel Inc.
	Steel processing	Lafayette Metal Service Corp.
	Steel processing	Nisco Steel Services Inc.
	Steel processing	●Nova Steel Processing Inc.
	Steel processing	●Vicksmetal Corp.
	Aluminum, copper/steel processing	Alumax Inc., Prime Metals Division (6)
	Copper, nickel/steel processing	●Thinsheet Metals Co.
3442	Aluminum bath enclosures	Alumax Inc., Home and Specialty Products Group (5)
3443	Fabricated plate work	●Alerco and Hayward Steel, Inc.
3444	Aluminum products for housing aftermarket	Alumax Inc., Alumax Fabricated Products, Inc. (2)
	Aluminum products for housing aftermarket	Alumax Inc., Home and Specialty Products Group (8)
	Aluminum products for mobile homes/recreational vehicles	Alumax Inc., Alumax Fabricated Products, Inc. (2)
	Aluminum products for housing aftermarket/mobile homes	Alumax Inc., Alumax Fabricated Products, Inc. (3)
	Aluminum rain-carrying components/other building products	Alumax Inc., Home and Specialty Products Group (5)
	Aluminum spectator seating, scaffolding/ceiling grid systems	Alumax Inc., Home and Specialty Products Group
	Sheet-metal ducts	●Alerco and Hayward Steel, Inc. (2)
3446	Architectural aluminum products	Alumax Inc., Kawneer Co., Inc. (4)
3462	Steel forgings	Tube Turns Inc.
	Steel automotive wheels	●Topy Corp.
3463	Aluminum/titanium forgings	International Light Metals Corp.
	Aluminum automotive wheels	●Enkenei America Inc.

	Aluminum wheels/other die-cast aluminum automotive products	Cast Forge Co.
	Aluminum transmission casings/other die-cast aluminum automotive products	•Sheller-Ryobi Corp.
3465	Automotive body stampings	•Diamond-Star Motors Corp.
	Automotive body stampings	•Mazda Motor Manufacturing (USA) Corp.
	Automotive body stampings	New United Motor Manufacturing Inc.
	Automotive parts stampings	•Ogihara America Corp.
	Automotive seat frames	Bellemar Parts Industries Inc.
	Automotive seat frames	Tri-Con Industries, Ltd.
3469	Lead frames for integrated circuits	International Leadframe Corp.
	Lead frames for integrated circuits	•Koltron Corp.
	Lead frames for integrated circuits	Shinko Electric America Inc.
	Lead frames for integrated circuits	Sumitomo Metal Mining California Corp.
	Lead frames/other metal parts for integrated circuits	Kaga USA Inc.
	Metal stampings for integrated circuit lead frames	UGM, Inc.
3471	Plating/repair of press molds	•Teikoku Corp.
3479	Coating/repair of continuous steel casting molds	•Sumitec Inc.
3494	Welded steel fittings, engineered products	Tube Turns Inc.
	Expansion valves for automotive air conditioning systems	Fuji Koki America Inc.
3495	Precision springs	Kato Spring Inc.
	Precision springs	Kato Spring of Georgia Inc.
3496	Chain link	Master-Halco, Inc.
	Fittings for metal fencing	Master-Halco, Inc.
	Steel cord/bead wire for tires	ATR Wire and Cable Co.
3497	Electro-deposited copper foil	Oak-Mitsui, Inc.
3498	Steel threading for oil/gas drilling pipe	VAM-PTS Co.
Nonelectric Machinery		
3523	Farm tractors	Kubota Tractor Corp.
3524	Lawnmowers	Honda Power Equipment Manufacturing Inc.
3531	Construction equipment	•Komatsu America Manufacturing Corp.
3532	Mining equipment	•Komatsu America Manufacturing Corp.
3534	Elevators, escalators	Fujitec Industries, Inc.
3541	Numerically controlled lathes, machining centers	LeBlond Makino Machine Tool Co.
	Numerically controlled lathes, machining centers	•Mori Seiki U.S.A. Inc.
	Numerical controls	LeBlond Makino Machine Tool Co.
3543	Robotic systems	•GMF Robotics Corp.
3544	Welding positioners	•K.N. Aronson Inc.
3546	Carbide drills	Megatool Inc.
	Cordless drills	•Makita Corp. of America
3549	Gas-cutting equipment	•K.N. Aronson Inc.
3552	Monogramming/embroidery machinery	•Baruden America Inc.
3555	Electronic page makeup systems/color scanners for graphic arts industry	Dainippon Screen Engineering of America Inc.
	Rotogravure cylinders	•American Fuji Seal, Inc.
3559	Semiconductor assembly equipment	•YKC-Yamada Industries Inc.
	Components for automatic crimping machinery	Toyojamco Ltd.
3561	Pumps for low-temperature liquids	Cryodynamics Co.-Ebara Group
3562	Ball/rod-end bearings	•New Hampshire Ball Bearings Inc. (4)
	Ball bearings	IKS American Corp.
	Tapered/cylindrical roller bearings	•NTN-Bower Corp. (2)
3564	Small horsepower fans for computer motors	Nidec Torin Corp.
	Dust-collection equipment, electrostatic precipitators	•Mikropul Corp.
3568	Pulleys	Machine Specialties Co.
3569	Plasma spray equipment	•Electro-Plasma, Inc.
	Specialty gas handling equipment	Matheson Gas Products Inc. (9)
	Screening equipment for liquid-solid separation	Ando Screen Inc.
	Particle-size reduction equipment	•Mikropul Corp.
	Electronic fastening systems	FEC Inc.
	Heat-shrinkable plastic material application machinery	Templock/AFM Inc.
	Component parts	•New Hampshire Ball Bearings Inc., Scotia Division
3573	Computers	NEC Information Systems, Inc.
	Computer disk drives	•Fujitsu America, Inc.
	Computer disk drives	•Hitachi Computer Products (America) Inc.
	Computer printers	•Epson Portland Inc.
	Computer printers	NEC Information Systems, Inc.
	Computer keyboards	Hi-Tek Corp.
	Computer keyboards	SMK Manufacturing Inc.
	Computer keyboards, mouse input devices	•Alps Electric (U.S.A.), Inc.
	CRT display modules	Data Ray Corp.
3585	Heat exchangers, evaporators/condensers for automotive air conditioners	•Nippondenso Manufacturing U.S.A. Inc.
	Compressors/evaporators for automotive air conditioners	Wynn-Kiki Inc.
	Ice machines	•Hoshizaki America, Inc.
3599	Membrane modules for recovery of electro-deposited paint	Nitto Denko America, Inc.

Electric Machinery and Electronics

3613	Circuit breakers for power plants/transmission lines	High Voltage Breakers, Inc.
	Electronic fuses, fuse holders, fuse blocks, terminals/related equipment	San-O Industrial Corp.
3621	Voice-coil motors for computer disk drives	Systems Magnetic Co.
	Direct-current motors for computer equipment	Universal Magnetics, Inc.
	Motors for phonographs/audio equipment	Matsushita Electric of Puerto Rico, Inc.
3632	Refrigerator parts	Sanoh Manufacturing Corp.
3643	Electric/electronic switches	NKK Switches of America, Inc.
3644	Accessories for overhead transmission lines	●Alcoa Conductor Accessories Inc.
3647	Automotive lighting equipment	North American Lighting, Inc.
	Automotive/motorcycle lighting equipment	Stanley Electric U.S. Co., Inc.
3651	Audio/video professional equipment	Sony Professional Products Co.
	Color television sets	Hitachi Consumer Products of America Inc.
	Color television sets	●Mitsubishi Consumer Electronics America, Inc.
	Color television sets	NEC Home Electronics (U.S.A.) Inc.
	Color television sets	US JVC Corp.
	Automotive audio equipment	Alpine Electronics of America, Inc.
	Automotive audio equipment	Clarion Corp. of America
	Automotive audio equipment	●Pioneer Industrial Components Inc.
	Stereo speakers, record changers	Matsushita Electric of Puerto Rico, Inc.
	Paper cones for stereo speakers	Fuji Cone Inc.
3652	Digital audio discs	Digital Audio Disc Corp.
	Video discs	Pioneer Video Manufacturing Inc.
3661	Electronic private branch exchanges	Oki America Inc.
	Key telephone systems, push-button telephones	Iwatsu America Inc.
	Telecommunications equipment	●Toshiba America, Inc.
3662	Cellular mobile communications equipment	ASTRONET Corp.
	Cellular mobile communications equipment	Matsushita Communication Co.
	Cellular mobile communications equipment	●Mitsubishi Consumer Electronics America, Inc.
	Cellular mobile communications equipment	Oki America Inc.
	Cellular mobile communications equipment, mobile paging devices	NEC America, Inc.
	Cellular mobile/fiber-optic communications equipment, multiplexers, microwave radios	Fujitsu America, Inc.
	Fiber-optic transmission systems, cellular mobile communications equipment/other telecommunications products	NEC America, Inc.
	Mobile paging devices	Matsushita Electric of Puerto Rico, Inc.
	Video game machines	Nintendo of America, Inc.
	Coin-operated video game machines	●Atari Games Corp.
367	Cathode ray tubes	●Toshiba Westinghouse Electronics Corp.
3674	Silicon wafers	●NBK Corp.
	Integrated circuits	Mitsubishi Semiconductor America Inc.
	Integrated circuits	NEC Electronics U.S.A. Inc.
	Integrated circuits	Oki Semiconductor Inc.
	Discrete devices	●Powerex, Inc. (3)
3675	Ceramic capacitors	Kyocera Northwest Inc.
	Axial capacitors	Taiyo Yuden (USA), Inc.
3676	Thin-film resistive electronic components	Thin Film Technology Corp
3678	Connectors	Hirose Electric (U.S.A.), Inc.
	Connectors	Kel-Am, Inc.
3679	Audio cassette tapes	Sony Magnetic Products Inc.
	Multiwire boards	Hitachi Chemical Co. America, Ltd.
	Power supplies for computers/other equipment	●IMC Magnetics Corp.
	Cable assemblies, power supply units/related components for computers/peripheral equipment	Fujitsu America, Inc.
	Relays, sockets, switches/other electrical industrial components	IDEC Systems & Controls Corp.
	Wire harnesses for appliances	●Oxford Wire & Cable Services Inc.
3693	Medical electronics equipment	●Toshiba America, Inc.
	X-ray intensifying screens for medical use	MCI Optinix Inc.
3694	Ignition coils/electronic automotive components	●Hitachi Automotive Products (USA) Inc.
	Automotive wire harnesses	●American Yazaki Corp.

Transportation Equipment

3711	Cars	●Diamond-Star Motors Corp.
	Cars	●Mazda Motor Manufacturing (USA) Corp.
	Cars	New United Motor Manufacturing Inc.
	Bus chassis	●Isuzu Truck of America Inc.
3714	Automotive air conditioners, exhaust assemblies	Calsonic Manufacturing Corp.
	Automotive exhaust systems, catalytic converters, brake lines, door sashes	Bellemar Parts Industries Inc.
	Automotive fuel line/hydraulic brake assemblies	Curtis-Maruyasu America, Inc.
	Automotive turbochargers	Warner-Ishi Corp.
	Automotive windshield washers/heaters	Nippondenso Manufacturing U.S.A. Inc.
	Automotive seats	Tri-Con Industries, Ltd. (2)
	Automotive seats, wheels	Bellemar Parts Industries Inc.
	Automotive steering wheels	Neaton Auto Products Manufacturing Inc.

	Automotive arm bushing/joint assemblies	Musashi USA Inc.
	Automotive stamped/welded internal structural components	KTH Parts Industries Inc.
	Automotive molded plastic parts	●Diamond-Star Motors Corp.
	Automotive molded plastic parts	●Mazda Motor Manufacturing (USA) Corp.
	Automotive plastic instrument panels, radiator grilles, console/glove boxes, bumpers/splash guards	Kantus Corp.
	Automotive door trim/other interior trim products	●AMTEX Inc.
	Automotive extruded rubber products	●CKR Industries, Inc.
	Automotive glass fittings	●Beiletech Corp.
3728	Aircraft propellers	Pacific Propeller, Inc.
	Aircraft interior equipment	Japan Aircraft Maintenance (America), Inc.
3743	Subway cars	●Kawasaki and Nissho Iwai Partnership
3751	Motorcycle engines	Honda of America Manufacturing, Inc.
	Motorcycle seats	Bellemar Parts Industries Inc.
Precision, Medical and Photographic Equipment		
3825	Oscilloscopes	Kikusui International Corp.
3829	Calipers, micrometers	Mitutoyo Corp.
3832	Fiber-optic lens	NSG America Inc.
	Fiber-optic cables	●Alcoa Fujikura Ltd.
	Fiber-optic cables	Sumitomo Electric Research Triangle, Inc.
3841	Auto-refractometers, photocoagulators/other ophthalmologic instruments	Nidek Inc.
3842	Custom-designed hearing aids	Rion Acoustic Instruments, Inc.
3851	Coating of eyeglass lenses	●Pentax Ophthalmic Inc.
3861	Copiers	●Canon Virginia Inc.
	Photo-sensitive drums for copiers	U.S. Fuji Electric Inc.
	Toner/developer for copiers, duplicators/printers	Memorex DIC Corp.
	Toner/developer/other consummable supplies for photocopying industry	Tomoegawa (U.S.A.) Inc.
3873	Quartz clock movements	Takane USA, Inc.
Miscellaneous Manufactures		
3931	Musical drums	Pearl International Corp.
3949	Golf clubs	Daiwa Golf Co.
	Golf clubs	Honma Golf, Inc.
	Golf clubs	Mizuno Golf Co.
395	Writing instruments	Scripto Tokai Inc.
3999	Disposable cigarette lighters	Tokai of America Inc.
	Candles	Kameyama U.S.A. Inc.
	Men's custom hairpieces	●Alderans & Alfieri Inc.

●Previously unlisted plants that went into operation during 1985 or were under construction on December 31, 1985, as well as acquisitions that were finalized in 1985.

Note: Product lines are grouped in terms of the Standard Industrial Classification. A number in parentheses indicates that the relevant company produces its product line at more than one location.

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IMPROVING THE INTERNATIONAL TRADING SYSTEM

Summary

Although the General Agreement on Tariffs and Trade has enjoyed great success in reducing tariffs, it appears incapable of stemming the rising tide of protectionism. A declining share of world trade is handled by the GATT and that share is not handled very well. A new round of multilateral trade negotiations, which could begin in late 1986, is vital to improve the world trading system. And as in most previous rounds, participants should agree to forego additional barriers while the discussions are underway.

A key priority in trade talks will be the negotiation of a safeguards code that would bring the numerous voluntary restraint agreements under GATT discipline. GATT rules should also be extended to cover agricultural and service sector trade, which presently lie outside the GATT framework. Moreover, the industrialized countries should agree to phase out the Multi-Fiber Arrangement and bring developing countries into the mainstream of the GATT system.

World Trading System in Disarray

The General Agreement on Tariffs and Trade, established in 1948, was intended to reverse the mercantilist policies of the 1930s that helped produce the Great Depression. Negotiated as one of many agreements to be included in the proposed International Trade Organization, it became the trade agency by default after governments failed to ratify the ITO. Consequently, the GATT does not have the authority in trade that the International Monetary Fund exercises over finance or the World Bank over development. But GATT negotiations, which have lowered the average tariff on manufactured goods among major countries from 40 percent in the immediate postwar period to 5 percent today, have encouraged the expansion in world exports from $61 billion in 1950 to almost $2 trillion in 1984 (see Table 1).

Global trade, however, is being choked by a growing accumulation of restrictive measures that ignore or evade GATT rules. In response to the second oil shock and the worldwide recession of 1981-82, governments have increasingly relied on managed trade to protect jobs. Major segments of world trade have been removed from GATT's jurisdiction and subjected to "voluntary" restraint agreements negotiated under importers' threats. Of the top ten products in world trade (see Table 2), four -- cars, steel, textiles and clothing -- are largely controlled by discriminatory bilateral agreements. Furthermore, the developing countries, which account for an increasing share of world production, are largely outside the GATT system.

Although GATT's 90 member countries account for 80 percent of world trade, only some 20 percent of total trade is conducted under GATT rules, according to one study. Another report by a U.S. presidential commission claims that GATT rules now apply to less than 5 percent of world trade compared to 20 percent in 1950. These trends explain the spreading frustration at the GATT's inability to stem the rising tide of protectionism and resolve trade disputes. A declaration adopted at the ministerial meeting of the GATT in November 1982 begins with the warning that "The multilateral trading system . . . is seriously endangered." Many observers believe that unless something is done, GATT will become increasingly irrelevant.

The United States, with the support of Japan, has pushed for a new round of multilateral trade negotiations to improve the international trading system. This would be the eighth round. The first six, ending with the Kennedy Round (1963-67), focused on reducing tariffs. Subsequently, nontariff measures, which include many legitimate domestic policies, became the major barriers to trade. The success of the postwar trading system in promoting the integration of the global economy has blurred the line between domestic economic policies and foreign trade policies. The Tokyo Round, which ended in 1979, attempted to address many nontariff measures. Five years of hard bargaining produced seven codes covering areas such as government procurement, domestic subsidies, standards and import licensing procedures.

Despite the agreement by the major industrialized countries at the 1984 London Economic Summit to begin a new round, there has been a decided lack of enthusiasm for trade talks. Some observers argue that governments should fully implement the Tokyo Round agreements before beginning new negotiations. A GATT economist estimates that world exports would be 40 percent higher if current agreements were followed to the letter. Other analysts see too great a risk of failure in negotiations that could harm an already weakened world trading system and lead to the unraveling of current agreements. They note that negotiations have a better chance of success during periods of rapid expansion, but

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Table 1: World Exports, 1950-1984

(in billions of dollars)

Year	Agricultural Products	Minerals*	Manufactures	Total
1950	$28	$9	$23	$61
1955	33	17	42	93
1960	40	21	64	129
1965	50	31	103	187
1970	64	51	190	312
1975	150	207	501	875
1980	299	567	1,095	1,989
1981	294	550	1,090	1,963
1982	271	493	1,053	1,844
1983	267	453	1,057	1,807
1984	280	454	1,148	1,915

*Including fuels and nonferrous metals.

Source: General Agreement on Tariffs and Trade, International Trade 1984/85, p. 201.

Table 2: Major Products in World Trade, 1973 and 1983

(shares of value of world trade)

	1973	1983
Crude Petroleum	7.6%	12.4%
Petroleum Products	2.4	4.9
Cars	3.8	3.8
Steel	4.6	2.8
Textiles	4.1	2.6
Clothing	2.2	2.2
Data Processing Equipment	1.4	2.2
Automotive Parts and Accessories	2.2	2.0
Natural and Manufactured Gas	0.3	2.0
Plastics	1.9	2.0

Source: The Economist, January 4, 1986, p. 55.

the growth of world trade has slowed from 9 percent in 1984 to 3 percent in 1985. Furthermore, the consensus on the merits of liberalized trade has weakened substantially. Some believe that preservation of a way of life is preferable to the efficiency gains of reduced trade barriers. Others claim that widespread government intervention in economic affairs has distorted markets and destroyed the rationale for liberalizing trade.

A number of observers who view exchange rate misalignment as the major cause of the trading system's problems believe that reform of the international monetary system is more important than a new round of trade negotiations. A private-sector trade policy advisory committee, for example, expressed concern to the U.S. trade representative in May 1985 that trade talks would divert attention from this issue.

At the beginning of the floating exchange rate system in 1973, it was thought that exchange rates would respond primarily to changes in the trade balance. But short-term capital flows, which are affected by factors other than trade, are estimated to have reached $40 trillion annually and have swamped the $2 trillion in annual trade flows. Furthermore, the volatility of exchange rates has increased as a result of floating exchange rates, liberalized capital markets and advances in telecommunications. The combination of misalignment and volatility significantly increases the cost of foreign trade and makes planning more difficult. For this reason, France has insisted on parallel talks to reform the international monetary system.

In addition, the debt crisis has forced many developing countries to restrict imports to meet their debt service payments (see Table 3). World Bank figures show Third World debt totaled $950 billion at the end of 1985 and will exceed $1 trillion this year. Developing debtor nations paid about $22 billion more to banks and other lenders last year than they received in new loans.

While these factors have contributed to the problems of international trade, it is important to continue to work at lowering trade barriers. The history of the trading system argues that momentum is crucial: the system either moves forward toward increased liberalization or topples under protectionist pressures. A new round of trade talks would help prevent the collapse of the current system, as well as promote growth. According to an Institute for International Economics report, growth in world trade resulted in a 0.25 percentage point annual increase in world output between 1953 and 1973. A Brookings Institution study estimated that the benefits of the Tokyo Round were 50 to 100 times greater than the adjustment costs for the major industrial countries.

Measures to Improve GATT's Framework

After many delays, GATT members finally agreed at the November 1985 annual meeting to establish a preparatory committee to plan an agenda for a new round. Work began in January and is expected to be completed by June. If the agenda is approved at the September 1986 ministerial meeting, the new round will officially begin. Approximately 30 topics have been proposed for negotiation, reflecting the diverse interests of the member countries. The agenda should not only include measures to improve the existing framework but also to expand GATT's coverage to new areas. Two of the most important items in the former category are a safeguards code and improvement of the dispute settlement procedure.

Table 3: Trade Performance of Major Debtor Countries

(in billions of dollars; average annual real growth rates, 1980-84)

Country	Debt Outstanding, 1985*	Gross Domestic Product	Exports	Imports
Argentina	$ 50.8	-1.6%	3.6%	-14.7%
Bolivia	4.0	-4.7	-1.7	-15.8
Brazil	107.3	0.1	10.8	-7.3
Chile	21.0	-1.4	0.7	-4.2
Columbia	11.3	1.8	0.8	2.4
Costa Rica	4.2	-0.4	1.1	-9.1
Ecuador	8.5	1.1	2.6	-13.7
Ivory Coast	8.0	-2.3	1.3	-8.8
Jamaica	3.4	1.3	-2.5	-2.1
Mexico	99.0	1.3	10.5	-14.5
Morocco	14.0	2.5	4.1	-1.0
Nigeria	19.3	-4.7	-13.3	-12.1
Peru	13.4	-0.7	-0.6	-10.8
Philippines	24.8	0.8	3.6	-4.8
Uruguay	3.6	-3.7	2.2	-11.3
Venezuela	33.6	-1.8	-3.8	-19.3
Yugoslavia	19.6	0.6	-0.6	-8.1
Total	445.9	-0.3	1.8	-9.2

*Estimated total external liabilities, including International Monetary Fund credits.

Source: Washington Post, March 27, 1986, p. E3.

Safeguards Code - The rapid shift of comparative advantage among countries and the excess capacity that exists in many industries has led to increased pressure to restrict imports. Article XIX of the GATT allows temporary "safeguards" to protect industries that are found to be seriously injured by imports. The rules require prior notification and the affected countries are allowed to be compensated or can retaliate in response. The restrictions are to be applied in a nondiscriminatory fashion against the supplying countries, in line with GATT Article I, which calls for most-favored-nation treatment of member countries. One recent example was Washington's 1983 imposition of quotas and higher tariffs on specialty steel under Section 201 of the Trade Act of 1974. The European Community retaliated by restricting imports of sports equipment and some chemical products from this country.

Gradually, however, Article XIX has fallen into disuse as countries have increasingly relied on bilateral measures, such as voluntary restraint agreements and orderly marketing agreements, to protect domestic industries. The EC, for example, has negotiated 15 bilateral agreements restricting steel imports since 1978; the United States has signed 18 such agreements since 1984. A significant number of these measures restrict imports from Japan and newly industrialized countries in Asia (see Table 4). The increased use of these "grey area" measures is a major cause of the decline in GATT's prestige and effectiveness.

Table 4: Value of Manufactured Exports to OECD Countries Subject to Trade Restrictions

(in billions of dollars)

Country of Origin	Total Manufactured Exports 1980	Subject to Restrictions* In 1980	In 1983
Japan	$61.7	$ 7.0	$21.8
Korea	10.1	2.3	3.2
Taiwan	12.0	2.0	2.2
Hong Kong	11.8	3.4	4.2
Singapore	3.6	0.2	0.3
Total	99.2	14.9	31.7

*Product items subject to restrictions are:

Japan - 1980: steel; television receivers to United States; ships.
1983: steel; one-third of television receivers to European Community; ships; automobiles; motorcycles to United States.
Korea - 1980: one-half clothing and textiles; one-third footwear; television receivers to United States.
1983: two-thirds clothing and textiles; one-third footwear to European Community; one-half steel.
Taiwan - 1980: same as for Korea.
1983: same as for Korea.
Hong Kong - 1980: two-thirds clothing and textiles.
1983: four-fifths clothing and textiles.
Singapore - 1980: one-third clothing and textiles.
1983: two-thirds clothing and textiles.

Source: OECD Observer, May 1985, p. 18.

There are two basic causes for the virtual breakdown of the safeguard system. First, the stringent requirements involved in using the GATT system make it a less attractive approach. Using grey area measures, a country has no obligation to prove that imports have caused serious injury, can single out countries for restraints and is not required to pay compensation. Second, trade actions consistent with the GATT are insufficient in dealing with the difficulties faced by declining industries, such as falling demand or a shift in comparative advantage to other producers.

Although grey area measures may be no more severe than safeguard actions, they are potentially more troublesome for several reasons. Bilateral restraints generally penalize the most efficient producer and new market entrants, often developing countries. Furthermore, these restraints are easier to initiate and maintain since the affected countries do not challenge the agreements under the GATT. It is important, therefore, that GATT principles be applied to temporary import restraints to provide fairness and discipline.

Several countries, including the United States and Japan, have called for the negotiation of a safeguards code to reverse the current trend. The unsuccessful attempt to negotiate such a code during the Tokyo Round has been referred to as that round's single largest failure. Although the 1982 ministerial meeting agreed on the general principles for a safeguards code, negotiations remain stalemated.

A successful safeguards code would require members to sacrifice some of their economic sovereignty by allowing the GATT more control over politically sensitive issues. A code should include both incentives and sanctions to persuade countries to adhere to GATT principles in taking future safeguard actions. It would be useful if the GATT secretariat were given a role in designing and monitoring import restraint programs, similar to the IMF's role in debt negotiations. Statistical standards should be established to determine when serious injury that justifies restraints has occurred. Import restrictions should decline over time and a strict time limit should apply. Since the injured industry has generally lost international competitiveness, the restraint program should foster contraction rather than revival. Moreover, it should not commit public funds to the industry or mandate private investment in that field.

Tariffs rather than quantitative restrictions should be used in safeguard actions. Domestic producers prefer the greater certainty of quotas, which better insulate them from market forces. But tariffs have the advantages of allowing imports to come from the cheapest source as well as providing revenue that can be used for worker assistance programs. Moreover, quotas establish incentives for their perpetuation, both for domestic producers and foreign exporters that hold the quota rights. The Organization for Economic Cooperation and Development reported, for example, that U.S. restrictions on Japanese steel increased Japanese profits by an estimated $200 million a year.

Controversy over whether safeguard actions may be imposed on targeted countries rather than on a nondiscriminatory basis prevented agreement on a code during the Tokyo Round. The EC argued that countries should be able to target only those nations causing the injury and not more established exporters. Developing countries, which fear that selective measures would discriminate against them, do not concur. A new safeguard code should prohibit selectivity because it lowers the cost of safeguard action and makes protection too easy.

Improvement of Dispute Settlement Procedures - A major weakness of the GATT is its inability to resolve disputes effectively. For instance, the United States complained in 1982 that the EC restricted imports of U.S. oranges and lemons. A panel did rule in favor of this country in 1985, but the EC ignored the ruling and blocked the report's adoption. Washington then abandoned GATT procedures and retaliated last November with higher tariffs on European pasta.

As this example indicates, the GATT does not have sufficient authority to impose a solution. Under the dispute settlement procedure, any member country can file a complaint alleging violation of GATT rules. A panel of experts is then established to judge the case. Since the member countries decide by consensus whether to accept the report, the alleged violater has the power to veto any recommendation -- a procedure that has been compared to having a policeman without a jail.

Further complaints hold that the GATT process is too slow, that there are too many opportunities for the "defendant" country to obstruct the process, and that decisions are often not implemented. According to an International Trade Commission survey, the process has resulted in termination of the disputed policy in only one-third of the completed cases. Some action, though, resulted in an additional 38 percent of the cases. The GATT has had some success in resolving disputes over tariffs and quotas, but it has been less effective in more complex cases involving subsidies and nontariff barriers.

The GATT's inability to enforce negotiated benefits has further contributed to disenchantment with the institution. This has encouraged countries to settle problems outside the system -- settlements that are often GATT-illegal, trade restrictive and damaging to third-country interests. Although the Tokyo Round did improve the dispute settlement procedure, and the 1982 ministerial meeting refined it further, additional steps are necessary. The establishment of a permanent panel of professional experts and strict time limits would improve the quality and speed of the process. And more fundamentally, the authority to pressure countries to implement the rulings is essential.

It is unlikely, however, that small procedural changes will substantially improve the dispute settlement process. Much of the problem reflects the difficulty of interpreting vague rules, particularly regarding agricultural commodities, and the underlying belief that trade issues are too important to be left to the GATT. Until countries develop the political will to submit to GATT discipline, the dispute settlement process will continue to be ineffective.

Extending GATT's Coverage

The GATT framework has been limited largely to manufactured goods. The new round of negotiations should bring services, agriculture and textiles into the system.

Services - The architects of the international trading system largely ignored the service sector, which includes such industries as banking, tourism, data processing, construction and engineering. Advances in telecommunications have facilitated the rapid transmission of data over long distances, enabling service industries to operate on an international scale. Although the liberalization of goods markets and capital markets has opened new international opportunities for the service sector, its exports often face import barriers more restrictive than those applied to manufactures. Moreover, constraints on foreign investment make it difficult for firms to establish the permanent facilities they need to compete successfully in local markets. Despite the lack of a coherent system of principles and procedures, global trade in services is estimated at $400-$500 billion annually, approximately 20 percent of world trade in goods and services.

Critics of the U.S. push to liberalize trade in services argue that the United States already dominates world trade in this field and would be the chief beneficiary of liberalization. Actually, trade in services is dominated by about 25 countries, which account for almost 90 percent of the total. Although the United States is the largest exporter of services (see Table 5), it is hardly dominant, accounting for only 10.8 percent of the total.

Table 5: Value of Service Exports, 1982

(in billions of dollars)

Country	Services*	Merchandise	Total	Services as Percent of Total
Argentina	$1.4	$7.6	$9.0	15.6%
Australia	3.7	20.8	24.5	15.1
Brazil	1.7	20.2	21.9	7.8
Canada	7.3	70.5	77.8	9.4
Japan	20.4	137.7	158.1	12.9
Korea	6.3	20.9	27.2	23.2
United Kingdom	28.5	97.0	125.5	22.7
United States	38.4	211.0	249.4	15.4
West Germany	29.3	171.9	201.2	14.6

*Excluding investment income and government services.

Source: General Accounting Office, Current Issues In U.S. Participation In The Multilateral Trading System, 1985, p. 41.

Some developing countries, led by Brazil and India, have insisted that the GATT applies only to trade in goods. International rules on service trade, they argue, would permit foreign interference in sovereign areas, such as banking, a key element in development policy. Those countries that have taken protective measures to foster their own information and communications sectors use the "infant industry" argument to oppose a code. They fear that powerful multinationals enjoying large economies of scale would destroy their service industries.

Key industrial countries, including Japan, are on record favoring the inclusion of services on the agenda. Given its rising share in the economies of advanced countries, service trade is too important a sector to leave out of the new round. In 1983, for example, services accounted for 57 percent of the U.S. gross national product (excluding the government sector) and employed 50.6 million workers, compared to 23.6 million in the manufacturing sector. The share of services in GNP exceeds manufacturing in other countries as well, including Japan and Great Britain. Despite its rising importance in domestic economies, service exports have been increasing more slowly than exports of merchandise -- illustrating the need for an agreement to liberalize trade. Such an agreement could benefit the developing countries by promoting an inflow of capital.

The efficiency arguments that support free trade of goods apply equally to services. The world economy loses from small-scale, inefficient service industries designed to serve single-country markets. Furthermore, liberalization of trade in services will promote free trade of goods, since services are intimately linked with trade in goods. Exports of many products depend on services, including transportation, communications, advertising, distribution and repair.

The 1982 ministerial meeting initiated a program for interested parties to gather and exchange information on service sector trade issues. The GATT secretariat became involved in these discussions in 1984. At the February 1986 meeting of the preparatory committee, however, Brazil and India remained opposed to the inclusion of services on the agenda for the new round. After negotiations begin, progress is likely to be slow given the complexity of the issues, which go beyond traditional commercial considerations and include questions of culture, privacy and national security. Domestic regulatory policies, which account for many of the nontariff barriers to service sector trade, are difficult to quantify and remove. Furthermore, government monopolies dominate many service industries.

Given the strong opposition of some developing countries, it is unlikely that an agreement based on the MFN principle can be reached. Instead, an agreement that all GATT members are free to join, such as the subsidies code, is the most likely result. Since negotiations are likely to last for some time, an important first step is to take action to prevent the introduction of new barriers. Talks begun in 1984 to include services in the government procurement code may also be useful.

Some observers argue that since each service industry is different, a sector-wide agreement is impractical and that a series of codes is preferable. But any code that is negotiated should be based on the principles of transparency and national treatment. Transparency requires open and unambiguous trade regulations -- a critical requirement since many service barriers are in the form of domestic regulations. The most contentious issue in national treatment will be whether it includes the right to establish local affiliates. Since many service industries, such as banking, require foreign investment, this would extend GATT coverage to investment. Lastly, an agreement should include effective dispute settlement and enforcement procedures.

Agriculture - Agricultural products accounted for about 15 percent of world trade in the early 1980s. But since 1955, when the United States obtained a waiver of GATT obligations to allow it to continue its domestic farm programs, agriculture has generally been outside the process of trade liberalization. Most countries pursue farm programs that are inconsistent with liberalized trade in order to achieve other goals, such as food security and income maintenance for farmers.

The rules that do exist are littered with loopholes. For example, the subsidy code permits export subsidies for primary products as long as they are not used to acquire more than a "fair and equitable share of the market." This provision has led to numerous disputes over what qualifies as a primary product and what constitutes a fair and equitable share. The dispute settlement process has struggled, often unsuccessfully, with agricultural issues, which account for more than 60 percent of GATT cases involving a specific product.

While the major disputes in farm trade involve export subsidies and quantitative restrictions on imports, the fundamental problem concerns domestic farm policies. In general, developing countries adopt policies that favor other sectors of the economy at the expense of agriculture, while developed countries do the opposite. In many advanced countries, price supports for farm goods raise prices far above world levels, thereby requiring import quotas to protect domestic markets. This naturally leads to overproduction, which in turn encourages export subsidies to get rid of surpluses. In particular, the EC's Common Agricultural Policy is under attack from all sides for increasing Europe's market share through subsidized exports. In 1984 the EC displaced the United States as the world's largest grain exporter. At the same time, though, U.S. import controls under Section 22 of the Agricultural Adjustment Act of 1933 raise sugar prices to five times world levels, while Japanese policies keep the price of rice four times world levels.

Agricultural trade was largely ignored in previous rounds. But friction over export subsidies led to the establishment of the Committee on Trade in Agriculture in 1982 to establish an agenda for multilateral negotiations. It is important to make some progress in this area, both for its own sake and to prevent animosity over agricultural disputes from spilling over into other areas, as occurred during the Kennedy and Tokyo Rounds. Last week, following the U.S. threat to retaliate against EC restrictions on imports of farm products, Sir Roy Denham of the EC warned that the disagreement threatens the start of a new round.

Several factors make the inclusion of agriculture in the new round more likely. First, there is increasing pressure from major exporters such as Australia, which has indicated that it may boycott negotiations if farm trade is not included. Second, budget constraints are likely to force reductions in domestic farm programs, allowing countries to claim credit for a trade concession. The EC faces a budget crisis this year due to spiraling farm costs, which account for three-fourths of its expenditures. West German Finance Minister Gerhard Stoltenberg told the EC that no new funds would be available until it brought the cost of farm programs under control. Budget constraints may also force a reduction in the United States, which spent an average of $19 billion a year from 1981 to 1983 on farm programs, nearly matching farm income of $23 billion. And in Japan, expenditures on "food control" are scheduled to fall 14.3 percent in fiscal 1986.

It is vital that the new round negotiate a limit on export subsidies, which have led to the dumping of farm products. Although the EC has rejected a U.S. proposal for a prohibition of such subsidies, some compromise should be possible. An agreement to phase out quotas on agricultural trade and improve the transparency of the system are also desirable.

But it will be impossible to bring agriculture fully into the GATT framework as long as countries continue their current farm programs. Agricultural policies illustrate the impact of domestic policies on international trade. Ideally, countries should follow market-oriented policies to reduce excess output and support farm income without providing incentives for overproduction.

Textiles and Apparel - Trade in textiles and apparel is largely exempt from GATT rules. Quantitative restrictions have been imposed on cotton textiles since 1961. The Multi-Fiber Arrangement, first negotiated in 1974, now serves as the framework for bilateral restraint agreements among 17 industrial nations and 34 developing countries, and covers 3,000 products made from cotton, wool and man-made fibers. Although developed countries generally do not apply quotas against each other, the MFA is a costly policy: one study estimates that it raises clothing prices in Great Britain by 20 to 50 percent.

Negotiations to replace the current MFA, which expires in July, began in earnest last week. The developing countries have called for freer trade in textiles, although some smaller producers enjoy the security of quotas under the MFA. President Reagan, though, in vetoing the protectionist Jenkins bill to limit textile imports in December 1985, promised to "aggressively renegotiate" the MFA to protect domestic producers.

The textile talks have important implications for the success of the new round. Many developing countries will have little interest in negotiations if there is no movement toward freer textile trade. While an immediate return to free trade would lower costs, it is politically infeasible and would entail a severe dislocation after so many years of protection. A more viable solution is to return textiles to GATT rules through a gradual phaseout of the MFA during the next 10 years.

A compromise on textiles may help bring developing countries into the mainstream of GATT. They account for an increasing share of world trade as indicated by the fact that Taiwan and Korea have moved ahead of traditional exporters Switzerland and Sweden. Developing countries are presently accorded "special and differential" treatment under Part IV of the GATT through preferences and easier access to exemptions, and are not required to make reciprocal concessions in negotiations. Consequently, import barriers are much higher in most developing countries.

Actually, this special treatment is of limited value to Third World nations, while GATT has neglected many important issues of concern to them. Because the developing countries were not required in past negotiations to give reciprocal concessions to advanced countries, they got little in return. For instance, tariff escalation (see Table 6) limits the development of processing industries in raw material supplying (mainly less developed) countries, and encourages them to remain "hewers of wood and drawers of water." If developing countries become more fully integrated into the GATT framework, they will have more weight in improving the trading system in the new round.

Although the developing world is critical of the Tokyo Round results, the industrialized countries should draw them into the trade talks by offering to negotiate a safeguards code, work out effective rules for agricultural trade, liberalize trade in textiles and lower tariffs on processed goods. In turn, the developing countries should agree to negotiate a code on trade in services and reduce barriers to trade and investment. Although these are termed "concessions," they will actually promote faster economic growth. The more advanced developing countries will also have to consider "graduation" so that preferential treatment can be focused on poorer countries. Last week, the United States withdrew duty-free privileges on $2.8 billion worth of products from Taiwan, Hong Kong, Korea, Singapore and Mexico.

Table 6: Average Tariff Rates In Major OECD Countries

	United States	Japan	Canada	European Community
Finished Manufactures	6.9%	6.4%	8.1%	7.0%
Semifinished Manufactures	6.1	6.3	6.6	6.2
Raw Materials	1.8	1.4	2.6	1.6

Source: G.C. Hufbauer and J.J. Schott, Trading For Growth: The Next Round of Trade Negotiations (Washington, D.C.: Institute for International Economics, 1985), p. 77.Conclusion

Conclusion

It is essential that trading countries make progress in reversing current protectionist trends. One weakness, however, of the GATT tradition of operating by consensus is that a relatively small number of countries can stall the negotiations. If this occurs, countries that favor trade liberalization may be forced to adopt alternative strategies, such as the free trade area (FTA) negotiated between the United States and Israel in 1985.

There are several advantages to FTA negotiations. First, it tends to reverse the usual incentives in international trade talks by making countries eager to be the first to agree to liberalized trade rather than the last. Previously, countries hoarded trade barriers as bargaining chips to use in lowering other countries' barriers. With a FTA, though, each side has a reason to be the first to join in order to gain an advantage over outsiders. In addition, the incentives for outsiders to join increases as the FTA grows and trade diversion increases. Second, FTA negotiations allow countries to use free trade rather than protectionism as a lever on countries reluctant to make trade concessions. Threats of protectionism are often not credible since the country imposing the restrictions is frequently hurt as much as, or more than, the foreign country.

Many observers criticize possible FTA initiatives as a regression to the narrow, bilateral trade negotiations that characterized the 1930s. The EC's Roy Denham, for example, termed this approach a "step backwards that would fragment nations into a number of clubs." This need not be the case, however. There are GATT criteria for permissible FTAs and plurilateral agreements, such as the EC. Moreover, there is nothing intrinsically bilateral about an FTA. An FTA would be as multilateral as the number of countries that joined the agreement. Finally, regional FTAs could be the building blocks of multilateral trade liberalization in the long run.

For further information, contact Randall S. Jones.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI REPORT

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Maekawa Commission Report Unveiled

A panel of advisers to Prime Minister Yasuhiro Nakasone formally submitted a report April 7 calling for changes in Japan's export-oriented industrial structure to reduce the nation's current account surplus. The Advisory Group on Economic Structural Adjustment for International Harmony, headed by former Bank of Japan governor Haruo Maekawa, produced an 11-page report following five months of debate.

The report outlines principles for transforming Japan's economy to growth based on domestic demand (see JEI Report No. 13B, April 4, 1986). To

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Although England and West Germany have completed arrangements to allow SDI participation, Tokyo has remained cautious toward the program for a variety of political and technical reasons. Nevertheless, the Department of Defense's emphasis on Japanese involvement remains high due to Japan's unquestioned status as a potentially significant contributor to the research. Pentagon officials are also interested in Japanese cooperation in light of Tokyo's cap of 1 percent of gross domestic product on overall defense spending. While it is unlikely that the program would founder without Japanese participation, it appears that DOD feels the plan's chances for success would be much greater with it. Although the nature of Japanese participation is uncertain, most observers feel that Tokyo will be involved in the program. A decision is expected by the May summit at the latest.

Mr. Weinberger also used the Japan leg of his Far Eastern tour to focus attention on other security issues by beginning his visit in Hokkaido. The secretary's presence on the island drew attention to Japan's dispute with the Soviet Union over the status of four islands just to its north. Both countries' claim to the islands presents a serious obstacle to improved relations and the negotiation of a peace treaty. Mr. Weinberger's stopover helped underscore American support for the Japanese position in the dispute. In addition, Mr. Weinberger observed units of the Ground Self-Defense Forces, thereby implicitly emphasizing their importance in the defense of Japan. The GSDF have come under severe pressure in recent years, as budget and security analysts have called for increased utilization of Air and Maritime Self-Defense Forces while reducing the land element to provide more effective -- and less costly -- defense. In effect, the secretary of defense underscored the continued need for the GSDF without injecting himself into the discussion of Japan's most appropriate defense role and force level.

Michael W. Chinworth

Trade Gap Continues To Separate China And Japan

Trade continues to dominate Japan's relations with China despite economic reforms by both countries aimed at alleviating trade pressures. While Japan chalked up a record trade surplus in 1985 with its giant communist neighbor, the two nations recently signed a five-year pact that will promote even greater trade flows. Chinese leaders have hinted that a political solution to the trade imbalance must be reached, a suggestion that Tokyo has staunchly resisted.

At the heart of the problem lies the phenomenal growth of the bilateral trade imbalance. Japan's exports to China surpassed its imports in 1984 for the first time, but the difference was relatively minor at $1.3 billion. In 1985, however, Japanese exports grew 72.9 percent while imports rose only 8.8 percent, pushing the surplus up to just under $6 billion (see Table). Movements of this magnitude have understandably caught the attention of Beijing.

Throughout the second half of 1985, Chinese leaders maintained a chorus of warnings that the rapidly deteriorating bilateral trade situation was unacceptable and that if Japan did not act to slow its exports, Beijing would. The Japanese responded that the sharp rise in trade was due to the far-reaching

Japan's Trade With China, 1984-85

(in millions of dollars)

	1984	1985
Exports		
Food	$20.5	$19.9
Textiles and Apparel	382.6	471.4
Synthetic Yarn	70.6	107.9
Clothing	3.9	4.8
Chemicals	610.2	713.0
Fertilizers	16.5	12.1
Pharmaceuticals	14.8	14.7
Plastics	254.8	349.2
Nonmetallic Mineral Manufactures	47.0	90.5
Metals and Fabricated Metal Products	2,842.8	3,529.9
Steel	2,668.1	3,192.6
Nonferrous Metals	80.3	164.5
Metal Products	94.5	172.8
Nonelectric and Electric Machinery	2,961.4	7,106.1
Nonelectric Power Generating Equipment	70.9	112.0
Office Machinery	67.8	122.7
Metalworking Equipment	47.7	182.7
Textile Equipment	83.3	271.9
Electric Power Machinery	40.1	112.6
Televisions	363.9	1,073.6
Radios	49.2	94.0
Electronic Components	70.7	160.3
Motor Vehicles	471.2	1,501.6
Motorcycles	68.9	205.1
Precision Equipment	142.4	250.3
Other	352.1	546.6
Total	7,216.7	12,477.4
Imports		
Food	630.3	934.7
Textile Raw Materials	286.4	354.7
Metal Ores and Scrap	9.7	9.3
Other Raw Materials	503.9	463.0
Soybeans	103.9	75.9
Mineral Fuels	3,093.1	2,970.0
Coal	204.3	184.0
Crude Oil	2,314.8	2,198.8
Petroleum Products	542.7	586.1
Chemicals	247.8	301.9
Pharmaceuticals	17.7	17.6
Nonelectric and Electric Machinery	14.7	18.1
Metalworking Equipment	1.0	1.7
Precision Equipment	5.4	7.0
Other	1,171.9	1,430.9
Steel	7.7	4.3
Nonferrous Metals	32.3	84.8
Textiles	888.0	956.8
Toys and Games	1.9	3.0
Total	5,957.6	6,482.7

Source: Japan Tariff Association, The Summary Report: Trade of Japan

economic reform programs that Beijing was implementing. The increased use of free-market mechanisms and decentralized economic planning, particularly for investment decisions, played havoc with China's foreign exchange reserves and trade flows. Several cases of improper activities were uncovered in China's special economic zones (areas that enjoy significant economic autonomy and are meant to be showcases for development), which added to the pressure on Beijing to reassert economic control. Japan's hands were not exactly spotless either, however. In one well-publicized case, used cars and motorcycles were sold as new, and in another, faulty refrigerators and air conditioners were delivered. Despite these unsavory instances, Chinese consumers avidly purchased Japanese electronic and household appliances whenever possible. Decades of frugality clearly resulted in a great amount of pent-up demand.

By late 1985, in an effort to slow the accumulation of red ink, China had clamped down on foreign exchange transactions, new and existing contracts, and the importation of several items, including cars and other consumer durables. Although this led to some grumbling by Japan's smaller trading companies, Tokyo acknowledged the need for action. In mid-January, Japan committed itself to buying more coal, crude oil, petroleum products and agricultural commodities from China over the next five years. The agreement will mean purchases of 8.8-9.3 million metric tons of crude oil a year (up from just under 8 million metric tons in 1985) and 3.7-4.1 million metric tons of coal. Discussions on purchases of agricultural products and light manufactures, particularly textiles, will be held within the year.

For its part, China has reiterated its commitment to its ambitious growth plans, signaling its intent to remain open to foreign trade. At the same time, however, Chinese leaders have also called for swift, cooperative action if the trade imbalance remains at present levels. Beijing does not enjoy being in debt to anyone and, unlike Tokyo, it can institute draconian measures if the need arises. Both countries are therefore expected to work out guidelines for a more stable economic relationship, which will probably entail greater direct investment and technology transfers from Japan to China.

Jon Choy

Europeans Try New Tack On Trade Relations With Japan

The European Community is apparently changing course in its efforts to find a solution to its growing trade deficit with Japan. After years of pressing Tokyo to tear down a broad range of tariff and nontariff trade barriers, the EC leadership is now pressing for negotiations on specific products. The inspiration for this approach clearly comes from the just completed U.S.-Japan market-oriented, sector-selective (MOSS) talks. In addition, however, the EC has suggested that it may question Japan's trade privileges resulting from adherence to the General Agreement on Tariffs and Trade. Such a suspension of GATT treatment would be unprecedented, and it is unclear exactly how it might be done.

EC foreign ministers adopted the surprisingly harsh stance on March 10 at a meeting dealing specifically with Japan. Despite an Executive Commission recommendation for a less confrontational policy, the Executive Council made

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JEI

REPORT

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JAPANESE FISCAL POLICY IN FY 1986: STEADY AS SHE GOES

Summary

Amidst the whirl of financial liberalization, deregulation and privatization that has gripped the Japanese economy since Yasuhiro Nakasone became prime minister, fiscal policy has been held to a steady course. For the fourth straight year, discretionary spending in the fiscal year that started April 1 has not been allowed to increase. Priorities have also remained fixed, with defense, official development assistance, and science and technology at the top of the list.

While this constancy is certainly admirable given the concern over the national debt, some policymakers are wondering whether it is the right course. In light of Japan's snowballing global trade surplus, Tokyo has come under increasing pressure to alter its tightfisted policies. While prospects for tax reform and deregulation are bright, fiscal policy is likely to remain on its present course at least through FY 1986.

Budget Basics

As a result of the American occupation of Japan after World War II, Japan's fiscal system has many elements in common with our own. The Ministry of Finance begins the budget process by issuing initial guidelines to other ministries and agencies in early summer. By fall each ministry has submitted its request, which is usually above the MOF guideline. MOF engages in negotiations with each ministry until December, at which time a compromise figure is reached. The entire budget is then approved by the cabinet and submitted to the Diet for passage.

The lower house of the Diet reviews the cabinet's budget but usually does not make any significant changes, since Dietmen have no power to introduce legislation. The deliberations, however, do provide for some degree of transparency because cabinet ministers are subjected to intense questioning about every aspect of the fiscal plan. Opposition parties can often wring concessions from the ruling Liberal Democratic Party by stonewalling or walking out of the budget debates as the March 31 deadline for passage of the package nears.

Once the lower house approves it, the budget automatically goes into effect 30 days later. Nevertheless, the upper house of the Diet also discusses and votes on the spending plan, providing another chance for questions and answers. If for some reason the budget is not ready when the new fiscal year starts on April 1, a provisional budget (similar to a continuing resolution in the United States) is approved. The provisional budget is absorbed into the full-year budget when it is finally passed.

A supplementary budget is usually devised and put into effect during the January-March quarter. This scheme gives the government some room for maneuver at the end of the fiscal year. Natural disaster relief, government wage increases, and public works projects usually make up the bulk of a supplementary budget.

On the revenue side, the process is still more flexible. Although the overall level and general sources of revenue are set at the same time as expenditures, the Japanese system allows for many alterations and special tax measures that can have a significant impact on fiscal policy. In the past two fiscal years, for example, opposition parties have demanded large income-tax reductions as the price for their votes on the budget. To compensate for such unforeseen shifts, a package of temporary tax measures is normally assembled. These special tax measures may be as minor as raising the tax on theater tickets or as important as introducing a new tax credit for research and development. Unlike the development of the spending program, the writing of the tax bill involves considerable give-and-take between the bureaucracy and political parties. Nevertheless, Japan's tax system is relatively free of loopholes and industry-specific provisions in comparison to the United States' tax picture.

How It's Spent

As for the structure of expenditures, Japan's system exhibits important differences. Four budgets account for the bulk of outlays: the General Account budget, the Special Accounts budget, the Government-Affiliated Agencies budget, and the Fiscal Investment and Loan Program. The General Account budget is directly analogous to the U.S. federal budget; it contains spending for social welfare, education, defense, revenue sharing and central government operations. In addition, however, it includes significant transfers to the Special Accounts budget. The General Account is funded by tax and bond revenues with the following exceptions: local road taxes, a special tonnage duty on imports, a tax for the development of new energy sources, half of the liquefied petroleum gas tax, a portion of the crude oil customs duty, a quarter of the motor vehicle tonnage tax, and two-thirteenths of the aviation fuel tax.

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The financing and administration of specific projects or funds fall under the Special Accounts budget. This includes, for example, the Mint Bureau, the National Forest Service, harbor and airport improvement projects, the Postal Savings system, certain government insurance programs, national schools and hospitals, the Trust Fund Bureau (which manages all government pension funds), several energy development projects, and the National Debt Consolidation Fund. Each special account has its own revenue source, such as transfers from the General Account, receipts from government enterprises administered under the Special Accounts, social insurance contributions, or interest from loans. Domestic and foreign bonds may also be issued to fund special accounts.

Government-affiliated agencies that are legally separate from the government have their own budget. Although all funding for these agencies comes from the Treasury, day-to-day operations are independently managed. Because funding comes from national coffers, the Diet must approve all agency budgets. Until recently, three public monopolies represented the majority of this account: Japan Tobacco and Salt Public Corp., Nippon Telegraph and Telephone Public Corp. and the Japanese National Railways. With the privatization of JTS and NTT in April 1985 and the impending transfer of JNR to the private sector, however, the size of the account will be greatly diminished. The remaining agencies include the Housing Loan Corp., the Small Business Finance Corp., the Hokkaido and Tohoku Development Finance Corp., the Japan Development Bank and the Export-Import Bank of Japan.

Finally, the Fiscal Investment and Loan Program, the so-called second budget, lists various investments and loans through the government, financed with funds entrusted to the government. To quote the Ministry of Finance, the FILP's purpose is "the enhancement of public policy especially in the fields of housing, public service facilities (highways, railroads and miscellaneous services), and medium- and small-size enterprises." Recipients of FILP monies can be divided into six groups: special accounts (which include urban development loans, national hospitals and schools and the postal system); major public corporations like JNR; finance corporations (including the Housing Loan Corp., the Small Business Finance Corp., several development corporations, the Japan Development Bank and the Export-Import Bank); public enterprises (such as the Environmental Pollution Service Corp., the Japan Regional Development Corp., the Japan Highway Corp., the New Tokyo International Airport Corp., the Japan National Oil Corp., the Japan Science and Technology Information Center, and the Overseas Economic Cooperation Fund); local government transfers; and other companies (Japan Air Lines Co., Ltd., the Shoko Chukin Bank Ltd., the Kansai International Airport Co., Ltd. and the Electric Power Development Co., Ltd.).

There are four sources of FILP money: the Postal Savings Fund and the Trust Fund Bureau, the reserve funds of the Postal Life Insurance and Postal Annuity special accounts, the Industrial Investment special account, and domestic construction bonds issued by public corporations such as JNR and the Japan Highway Public Corp. (The government guarantees the payment of principal and interest on these bonds.) Diet approval of appropriations from the Industrial Investment special account and of any issue of government-guaranteed bonds has always been mandatory. After FY 1972, however, the Diet also voted on appropriations from the remaining two sources since the FILP had grown to nearly half the size of the General Account.

How It's Paid For

There is very little difference between Japan's taxation system and that of the United States -- an unsurprising situation since the U.S. system was the model for Japan's. There is a great reliance on direct taxes, with personal and corporate income taxes accounting for almost 70 percent of total tax revenues. Personal income tax rates remain highly progressive, with the top bracket set at 70 percent for individuals with incomes of over Y80 million ($444,000 at Y180=$1.00). Corporate tax rates are set at 31 percent for nondividend income up to Y8 million ($44,000) and 43.3 percent above this level. A wide range of other taxes on energy supplies, commodities and luxuries supplements these levies. (See Table 1 for a detailed breakdown of tax receipts.)

Nevertheless, General Account expenditures are heavily reliant on borrowed money. In FY 1986, after four years of austerity, bonds worth one-fifth of total General Account outlays will be issued. Although this is a great improvement over the FY 1979 budget, when over one-third of revenues came from bonds, it is still too high in the eyes of Finance Ministry officials and the prime minister.

Other sources of government funds are likely to be put under pressure as the pace of financial liberalization accelerates. As Japanese plan for retirement, they will demand increasingly higher returns from pension and insurance funds. Although no Japanese version of the U.S. Individual Retirement Account is planned, the government pension system could become uncompetitive in relation to private systems as financial deregulation takes hold. Furthermore, if the tax-exempt status of interest earned on small deposits is repealed, the Postal Savings system would be hard hit. Should these two pools of money begin to dwindle, the Fiscal Investment and Loan Program may come up short. While this scenario is certainly some years off, policymakers are already concerned.

The Picture For FY 1986

Outlays - The iron grip of austerity continues to squeeze nondiscretionary expenditures (see Tables 2 and 3), as FY 1986's initial General Account budget shows a tiny decline of Y1,235 million ($6.7 million) from the previous year's preliminary budget. In order to achieve this feat, practically every category has been cut, the exceptions being social security, promotion of science and technology, and foreign aid. In contrast, nondiscretionary spending continues its upward climb. For the first time, debt-service payments will account for over one-fifth of total outlays. At the same time, transfers to local governments continue a pattern of normal growth since they are determined as a certain percentage of the receipts from several taxes.

Increased outlays planned in the Fiscal Investment and Loan Program will help to cushion the deflationary impact of the freeze on General Account spending (see Table 4). The strong jumps in spending for housing, water projects, roads and other transportation infrastructure are expected to ease pressure from politicians for pork-barrel spending.

Revenues - Here, too, Mr. Nakasone's priorities are clear. The issuance of government bonds will be reduced by over 6 percent, while direct and indirect taxes will be increased as compensation. Concern over the heavy dependence on direct taxes is also evident from the greater percentage increase planned for indirect levies. Unfortunately, the government has already run into problems meeting its estimates for FY 1985, and is likely to be hard pressed to keep to its ambitious bond-reduction program despite projected revenue increases due to normal growth and temporary tax measures.

Special tax measures for FY 1986 include stimulative provisions that will be paid for by businesses (see Appendix). A housing tax credit and special measures to promote private-sector involvement in public works projects will initially cost the government an estimated Y42 billion ($233 million). The extension of several of last year's tax increases on businesses, the repeal of another provision, and an increase in the tobacco excise tax are expected to raise an estimated Y383 billion ($2.1 billion) during the same period. Therefore, there will be a net gain of Y341 billion ($1.9 billion) for the fiscal year.

The lid on expanded bond issues also applies to the FILP budget. Such being the case, the demands placed on other income sources will increase proportionately. With the average age of the population increasing rapidly and financial liberalization spreading, the implications of such a shift in funding are clear.

The Bottom Line - There is little doubt that the impact of government spending will be neutral, if not negative, in FY 1986 despite the fatter FILP budget and the recently announced economic stimulus package (see JEI Report No. 15B, April 18, 1986). The government has been forced, therefore, into seeking other ways to stimulate domestic demand.

The Stronger Yen: Boon Or Bane?

The significant appreciation of the yen against the dollar and other currencies since September 1985 will undoubtedly have an impact on the budget. There is a wide divergence of opinion, however, over whether it will be positive or negative. In the short run it will probably increase outlays, because more businesses will become eligible for government assistance programs or be able to take advantage of tax provisions that help out companies in financial difficulties. Neither the stronger yen nor lower prices for crude oil are likely to decrease significantly the cost of energy conservation programs, since the government considers the fortuitous combination to be temporary.

Over the medium term, in contrast, planners are more optimistic. By FY 1989 the economy should have completed its readjustments to the stronger yen and faster growth should begin to return, ameliorating budget strains (see Tables 5 and 6). It should be noted, however, that these medium-term outlooks assume that the yen will stabilize and the deficit-reduction program will remain on course. Given current exchange-market and political realities, these assumptions are tenuous at best. (Note the major differences in outlooks made just one year apart.)

Other Items On The Agenda

Tax Reform - The momentum behind tax reform has finally resulted in the first significant step: the prime minister has appointed an advisory panel to study possible changes. Although Mr. Nakasone would like the first reforms to be ready for fiscal 1987, there still may be too many political barriers for such rapid action. The biggest hurdle is to overcome Finance Ministry concerns about how any changes will affect the revenue picture. A major element of reform, therefore, is expected to be tighter reporting and collection regulations.

The broad outlines of tax reform are clear: there will be a reduction in the number of personal income-tax brackets, a lowering of the top rates, more generous investment write-off provisions for businesses, and incentives for research and development. Beyond this, however, there is little agreement. Hot debate topics include the imposition of a major indirect tax modeled after the value-added tax used in Europe; new depreciation schedules incorporating much shorter lifespans for capital goods; the reduction or elimination of savings incentives; and the implementation of consumption incentives.

Administrative Reform - The deregulation and privatization programs in progress under the umbrella of administrative reform will have, if they have not already had, a significant impact on the fiscal picture. The boom set off by the deregulation of the domestic market for telecommunications equipment and services has undoubtedly opened new flows of revenue. The same can be said about the several steps taken as part of the liberalization of financial markets. The privatization of the tobacco, telecommunications and railroad public corporations will push these large enterprises off the government budget sheets, shrinking the overall numbers, if nothing else. There may be unforeseen consequences in terms of adjustment assistance, new legislation, and perhaps even the collapse of large enterprises that may create new fiscal pressures. On balance, however, Japanese planners are optimistic that the benefits of administrative reform will outweigh the costs.

Austerity: The Right Course?

Mr. Naksone's consistent fiscal policy is laudable from many standpoints. It has certainly become the hallmark of his administration, winning the prime minister respect for his determination to do what he feels is "right." This applies to both domestic and international politics. From an economic view, it provides a relatively stable base from which private businesses can plan their actions. It also addresses the long-term issue of the large national debt -- by tightening belts now, this policy may prevent a disaster farther down the road.

Many analysts, however, have questioned whether a disaster really lies in wait. Because of Japan's very high savings rate (both corporate and individual), there is little possibility that heavy government borrowing will crowd out private-sector investment. If the government creates the necessary financial infrastructure (sufficiently free of regulation), then it should have no trouble rolling over the debt. Indeed, such a rollover process has the potential for becoming a major market, as it is in the United States.

On the other hand, fiscal conservatives point to the aging population and the economic challenges posed by new technologies and rapidly advancing Third World countries as justification for maintaining a hard line on spending. Japan, they contend, will need a vast pool of savings, a lean government and a vital private sector to respond to new situations.

The intensity of the debate will increase whether the economy prospers or falters in the coming year, although certainly more if the latter occurs. If Tokyo is going to make a thorough attack on the trade and other problems it is experiencing with other nations, it cannot ignore imbalances in macroeconomic policies vis-a-vis those countries. There is general agreement that such a mismatch currently exists between Japan and the United States: they need to spend more and we need to spend less. This would seem to dictate an end to austerity, or at least a lengthening of the time frame for implementation. Whether or not Mr. Nakasone and the Finance Ministry move in this direction may depend on how the economy performs this year. Unfortunately, exchange-rate and commodity-price instabilities make current economic forecasts more tenuous than usual. It seems that for the time being, therefore, the sailing orders for Japan's fiscal policy are "steady as she goes."

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix: Summary of Tax Reform in FY 1986

Promotion of Home Purchases

1. The current system of a "credit for the acquisition of a dwelling house" will be replaced by the following:

> A taxpayer will be entitled to an income tax credit, up to an amount equal to 1 percent of the balance of the housing loan payment, calculated at the end of each year (limited to Y20 million).

2. The present "special tax treatment for a gift from parents or grandparents for acquiring residential properties," which is a temporary measure due to expire at the end of FY 1985, will be extended and expanded as follows:

- The maximum eligible amount will be raised from Y5 million to Y8 million.
- Old houses will be eligible for special treatment.

Promoting Private-Sector Vitality

3. To support financing of the "Trans-Tokyo Bay Highway," the following measures will be introduced:

- The profit from the redemption of an original issue discount bond, issued by particular companies in connection with construction of the highway, will receive special tax treatment.

- An amount equal to 10 percent of the sum invested in specific companies will be deductible from corporate income.

4. Depreciation of 13 percent in the first year of the amount spent on specified facilities as part of the "Private Sector Vitalization" program will be allowed.

5. To promote investment in energy-saving plant and equipment, a special depreciation allowance of 30 percent or a tax credit of 7 percent of the amount invested will be introduced.

6. Current investment incentives for small- and medium-size enterprises (30 percent special initial depreciation allowance or 7 percent tax credit) will be broadened.

7. The rate of depreciation (or tax credit) as specified in measures 5 and 6 above will be raised by 20 percent when imported equipment is purchased.

Rationalizing Special Taxation Measures

8. The reserve for price fluctuations will be abolished.

9. The proportion of revenues that small- and medium-size enterprises can set aside for overseas market development will be reduced.

10. The deferred value of the special treatment for the rollover of property, which allows accelerated depreciation, will be limited.

Amending Special Measures on Corporate Income Tax

11. The special additional tax of 1.3 percent, which was due to expire at the end of FY 1985, will be extended through FY 1986.

12. The carryover of losses from the previous year will be disallowed temporarily.

Other

13. The tobacco excise tax rate will be raised by Y450 per 1,000 cigarettes effective May 1, 1986. The higher rate will remain in effective to March 31, 1987.

Estimated Revenue Effects of FY 1986 Reforms

(in billions of yen)

	First Year	Out Year
Promotion of Home Purchases		
Tax credit change	Y-37	Y-30
Broader gift tax treatment	-2	-2
Total	-39	-32
Promotion of Private-Sector Vitality		
Special depreciation	-1	-1
Investment promotion	-2	-2
Total	-3	-3
Rationalizing Special Taxation Measures		
Reserve abolition	6	13
Rollover limitation	34	43
Other	0	-2
Total	40	54
Corporate Tax Measures		
Carryover loss limitation	223	0
Other		
Increased tobacco excise tax	120	135
Total	341	154

Source: Ministry of Finance

Table 1: Japan's National Tax and Stamp Receipts, FY 1983-FY 1984

(in billions of yen)

	FY 1983	FY 1984
General Account	Y32,358	Y34,908
Taxes	31,064	33,573
Personal Income Tax	13,643	14,063
Withheld	10,695	11,041
Self-assessed	2,948	3,022
Corporate Income Tax	9,824	11,341
Inheritance and Gift Tax	786	877
Liquor Tax	1,813	1,860
Sugar Excise Tax	39	42
Gasoline Tax	1,627	1,647
Liquified Petroleum Gas Tax	16	15
Aviation Fuel Tax	49	52
Petroleum Tax	337	388
Commodity Tax	1,295	1,495
Playing-card Tax	0.5	0.4
Bourse Tax	18	13
Securities Transaction Tax	418	506
Travel Tax	70	77
Admission Tax	8	8
Motor Vehicle Tonnage Tax	472	488
Customs Duty	640	692
Tonnage Duty	8	9
Others	0	0
Stamp Revenue	1,294	1,335
Special Accounts	797	848
Local Road Tax	293	296
Liquefied Petroleum Gas Tax	16	15
Aviation Fuel Tax	9	9
Motor Vehicle Tonnage Tax	157	163
Special Tonnage Duty	11	11
Customs Duty on Crude Oil	132	128
Energy Development Tax	180	227
Total	33,155	35,756

Source: Ministry of Finance

Table 2: Japan's General Account, FY 1982-FY 1986

(in billions of yen and percentage change)

	FY 1982 (revised)		FY 1983 (revised)		FY 1984 (revised)		FY 1985 (revised)		FY 1986* (initial)	
Total Expenditures	Y47,562.1	0.9%	Y50,839.4	6.9%	Y51,513.4	1.3%	Y52,499.6	3.7%	Y54,088.6	3.0%
Social Security	9,141.6	3.1	9,231.5	1.0	9,231.0	-0.0	9,573.6	2.7	9,807.4	2.4
Public Assistance	1,080.6	8.9	1,129.7	4.6	1,139.4	0.9	1,081.5	-5.1	1,103.4	2.0
Social Welfare	1,603.6	6.3	1,917.5	19.6	1,999.2	4.3	2,004.2	0.3	1,895.7	-5.4
Social Insurance	5,658.2	1.6	5,378.9	-4.9	5,347.9	-0.6	5,658.4	5.8	5,951.0	5.2
Health Service	425.6	1.7	435.4	2.3	467.0	7.3	462.1	-1.0	493.8	6.9
Unemployment	373.7	-2.2	369.8	-1.1	367.5	-0.6	367.3	-0.0	363.5	-1.1
Education and Science	4,832.6	0.2	4,834.3	0.0	4,866.5	0.7	4,840.9	0.2	4,777.8	-1.3
Compulsory Education	2,220.5	2.4	2,254.5	1.5	2,302.6	2.1	2,357.5	2.4	2,350.1	-0.3
Transfer to School Account	1,015.5	0.1	1,015.6	0.0	1,071.7	5.5	1,062.7	-0.8	1,074.3	1.1
Science Promotion	381.8	3.0	392.0	2.7	410.8	4.8	381.6	1.3	382.9	0.3
School Facilities	528.8	-9.3	489.8	-7.4	427.3	-12.8	385.1	-9.9	334.8	-13.1
School Aid	595.2	0.1	592.0	-0.5	567.9	-4.1	570.3	0.4	555.1	-2.7
Student Loans	90.8	0.2	90.3	-0.5	86.2	-2.3	83.8	-2.8	80.7	-3.7
National Debt Service	6,906.9	3.8	8,167.3	18.3	9,155.1	12.1	10,244.2	11.7	11,319.5	10.7
Pensions	1,891.7	4.9	1,890.0	-0.1	1,885.8	-0.2	1,863.7	-1.2	1,847.9	-0.8
Civil Servants	135.4	-0.5	132.7	-2.0	128.2	-3.4	124.8	-2.7	121.2	-2.9
Veterans	1,590.1	5.4	1,603.6	0.9	1,601.1	-0.2	1,578.7	-1.4	1,561.2	-1.1
Administrative Costs	10.3	3.4	10.6	2.3	10.5	-0.9	10.3	-1.7	10.3	0.2
War-bereaved Families	155.9	5.0	143.1	-8.2	146.0	2.0	149.9	2.7	155.2	3.5
Local Finance	7,976.4	-8.6	7,672.9	-3.8	9,219.0	20.2	9,690.1	9.0	10,185.0	5.1
Local Allocation Tax	7,535.2	-6.5	7,315.1	-2.9	9,036.1	23.5	9,690.1	6.8	10,185.0	5.1
Special Grants	0.0	**	2.0	**	0.0	**	0.0	**	0.0	**
Interest Support	441.1	-20.2	355.8	-19.4	182.9	-48.6	0.0	**	0.0	**
Defense	2,566.6	7.9	2,761.0	7.6	2,934.6	6.3	3,137.1	6.9	3,297.5	5.1
Public Works	7,281.3	4.0	7,224.3	-0.8	6,883.5	-4.7	6,368.9	-2.3	6,223.3	-2.3
Erosion, Flood Control	1,106.4	-0.1	1,107.4	0.1	1,098.5	-0.8	1,082.6	-1.4	1,048.3	-3.2
Road Improvement	1,891.9	-0.5	1,893.3	0.1	1,899.9	0.4	1,826.0	-2.5	1,767.6	-3.2
Harbors, Airports	522.6	-0.2	524.1	0.3	519.8	-0.8	511.8	-1.5	496.4	-3.0
Housing	877.9	4.1	894.3	1.9	915.0	2.3	757.7	-1.1	756.7	-0.1
Living Environment	987.2	0.1	988.2	0.1	980.3	-0.8	970.3	-1.0	957.0	-1.4
Agriculture	899.2	-0.1	900.0	0.1	891.9	-0.9	878.9	-1.5	856.7	-2.5
Forest Roads and Water	178.4	-1.2	177.1	-0.7	173.2	-2.2	169.6	-2.1	164.6	-2.9
Adjustment Reserves	11.7	-0.3	11.4	-3.1	10.9	-3.7	10.7	-2.2	10.5	-1.6
Disaster Reconstruction	806.1	47.2	728.4	-9.6	394.0	-45.9	161.3	-21.8	87.4	-45.8
Economic Cooperation	474.9	11.7	498.2	4.9	543.9	9.2	586.3	7.8	614.5	4.8
Small Business Measures	244.3	-1.7	238.9	-2.2	229.2	-4.1	216.2	-5.7	202.2	-6.5
Energy Measures	559.3	12.7	557.4	-0.3	603.2	8.2	628.8	4.2	623.4	-0.9
Food Price Supports	1,005.3	-0.9	917.2	-8.8	813.2	-11.3	695.4	-14.5	596.2	-14.3
Miscellaneous	4,451.0	-0.6	4,383.9	-1.5	4,354.9	-0.7	4,324.5	-1.0	4,164.0	-3.7
Others	0.0	**	2,232.5	**	125.3	**	0.0	**	0.0	**
Reserves	230.0	**	210.0	**	170.0	**	350.0	**	350.0	**
Total Revenues	47,562.1	1.7	50,839.4	6.9	51,513.4	1.3	52,499.6	3.7	54,088.6	3.0
Tax, Stamp Revenues	30,498.0	-4.2	31,902.0	4.6	34,835.0	9.2	38,550.0	11.4	40,560.0	5.2
Monopoly Profits	761.8	-2.2	1,004.2	31.8	3,414.9	-30.9	2,269.6	-32.3	2,582.6	13.8
Public Enterprise Receipts	14.4	17.7	15.1	5.1						
Sale of Public Properties	67.5	-7.7	82.7	10.3						
Miscellaneous	1,854.6	25.8	3,843.3	107.2						
Public Bonds	14,345.0	11.2	13,790.0	-3.9	12,865.0	-6.7	11,680.0	-7.9	10,946.0	-6.3

*Percentage changes for FY 1986 are based on the initial budget for FY 1985.
**Cannot be calculated or meaningless.

Source: Ministry of Finance

Table 3: Discretionary Spending in the General Account, FY 1982-FY 1986

(in billions of yen and percentage change)

	FY 1982		FY 1983		FY 1984		FY 1985		FY 1936*	
Total Expenditures	Y47,562.1	0.9%	Y50,839.4	6.9%	Y51,513.4	1.3%	Y52,499.6	3.7%	Y54,088.6	3.0%
Minus Debt Service and Transfers to Local Governments	14,442.2	-1.7	15,482.7	7.2	18,191.2	17.5	19,914.2	10.4	21,504.5	8.0
Equals Discretionary Spending	33,120.0	3.2	35,356.8	6.8	33,322.2	-5.8	32,585.4	-0.0	32,584.2	-0.0

*Percentage changes for FY 1986 are based on the initial budget for FY 1985.

Source: Ministry of Finance

Table 4: Uses and Sources of Japan's Fiscal Investment and Loan Program Outlays, FY 1982-FY 1986

(in billions of yen and percentage change)

	FY 1982		FY 1983		FY 1984		FY 1985		FY 1986	
Total Outlays	Y20,288.8	4.1%	Y20,702.9	2.0%	Y21,106.6	1.9%	Y20,858.0	-1.2%	Y21,753.6	3.5%
Housing	5,130.1	0.4	5,304.1	3.4	5,289.5	-0.3	5,289.3	-0.0	5,676.8	7.3
Water Works	2,863.2	5.4	2,764.8	-3.4	3,007.5	8.8	3,280.9	9.1	3,625.4	10.5
Welfare	701.3	6.5	652.0	-7.0	637.9	-2.1	595.7	-6.6	597.4	0.3
Education	762.8	-3.8	783.0	2.6	777.1	-0.8	745.3	-4.1	793.3	6.4
Small Business	3,905.9	2.1	3,942.2	0.9	3,968.3	0.7	3,764.4	-5.1	3,673.2	-2.4
Agriculture	906.8	-1.1	963.0	6.2	1,034.8	7.5	890.6	-13.9	865.8	-2.8
Land Conservation, Disasters	310.2	11.9	332.5	7.4	379.1	13.8	472.8	24.7	349.1	-26.2
Roads	1,472.6	24.5	1,583.7	7.5	1,711.7	8.1	1,826.4	6.7	2,006.4	9.9
Transportation and Communications	1,949.0	-0.3	1,924.6	-1.2	1,887.6	-1.9	1,763.4	-6.6	1,972.6	11.9
Regional Development	538.1	20.7	511.4	-5.0	500.0	-2.2	511.2	2.2	554.9	8.5
Industry and Technology	635.6	7.1	626.2	-1.5	620.3	-0.9	603.3	-2.7	609.7	1.1
Foreign Trade and Economic Cooperation	1,113.2	10.8	1,315.4	18.2	1,292.8	-1.7	1,114.7	-13.8	1,029.0	-7.7
Total Revenues	23,788.8	3.5	24,402.9	2.6	24,706.6	1.2	25,858.0	4.7	26,753.6	3.5
Industrial Investment Special Account	18.9	0.0	5.2	-72.5	4.8	-7.7	31.4	554.2	28.6	-8.9
Trust Fund Bureau Fund	19,568.9	0.5	19,135.3	-2.2	18,905.2	-1.2	20,029.0	5.9	20,370.0	1.7
Postal Savings	7,000.0	9.4	7,900.0	-11.2	7,900.0	0.0	6,900.0	-12.7	6,400.0	-7.2
Pensions	4,300.0	8.9	4,300.0	10.3	4,100.0	-4.7	3,850.0	-6.1	3,950.0	2.6
Payments, etc.	9,070.0	-6.3	7,368.9	10.3	7,135.3	-3.2	8,155.2	14.3	9,679.0	18.7
Postal Life Insurance Fund	1,981.0	4.8	2,354.4	18.8	2,586.6	9.9	2,587.6	0.0	3,145.0	21.5
Government Guaranteed Bonds and Borrowings	2,220.0	38.7	2,908.0	31.0	3,210.0	10.4	3,210.0	0.0	3,210.0	0.0

Note: All figures are based on initial budgets.

Source: Ministry of Finance

Table 5: Medium-Term Budget Projection, FY 1984-FY 1988

(in billions of yen and percentage change)

	FY 1984		FY 1985		FY 1986		FY 1987		FY 1988	
Payments										
Debt Service	Y9,155.1	11.7%	Y10,224.1	11.7%	Y12,930.0	26.5%	13,800.0	6.7%	Y14,550.0	5.4%
Transfers to Local Governments	8,886.4	21.5	9,690.1	9.0	10,330.0	6.6	11,140.0	7.8	12,010.0	7.8
General Expenditures	32,585.7	-0.2	32,585.4	-0.0	34,660.0	6.4	36,070.0	4.1	37,430.0	3.8
					[35,180.0	8.0	37,150.0	5.6	39,110.0	5.3]
Current Expenditures	24,654.9	1.1	24,951.3	1.2	26,910.0	7.9	28,250.0	5.0	29,530.0	4.5
					[27,310.0	9.5	29,100.0	6.6	30,860.0	6.0]
Capital Expenditures	7,930.8	-3.7	7,634.1	-3.7	7,750.0	1.5	7,820.0	0.9	7,900.0	1.0
					[7,870.0	3.1	8,050.0	2.3	8,250.0	2.5]
Total Payments	50,627.2	0.5	52,499.6	3.7	57,920.0	10.3	61,010.0	5.3	63,990.0	4.9
					[58,440.0	11.3	62,090.0	6.2	65,670.0	5.8]
Receipts										
Tax Revenues	34,596.0	7.1	38,550.0	11.4	41,290.0	7.1	44,240.0	7.2	47,400.0	7.2
Non-tax Revenues	3,351.2	-29.0	2,269.6	-32.3	2,370.0	4.4	2,530.0	6.5	2,690.0	6.5
Government Bonds	12,680.0	-8.0	11,680.0	-7.9	10,530.0	-9.8	9,380.0	-10.9	8,230.0	-12.3
Deficit Bonds	6,455.0	-5.2	5,730.0	-11.2	4,580.0	-20.1	3,430.0	-25.1	2,280.0	-33.5
Construction Bonds	6,225.0	-10.8	5,950.0	-4.4	5,950.0	0.0	5,950.0	0.0	5,950.0	0.0
Total Receipts	50,627.2	0.5	52,499.6	3.7	54,190.0	3.2	56,150.0	3.6	58,320.0	3.9
Shortfall (Total Payments minus Total Receipts)	--	--	--	--	3,730.0	--	4,860.0	--	5,670.0	--
					[4,250.0	--	5,940.0	--	7,350.0	--]
Current Expenditures	--	--	--	--	3,610.0	--	4,680.0	--	5,450.0	--
					[4,010.0	--	5,530.0	--	6,780.0	--]
Capital Expenditures	--	--	--	--	120.0	--	180.0	--	220.0	--
					[240.0	--	410.0	--	570.0	--]

Note: Figures in brackets allow for new stimulative spending.

Assumptions: For debt service costs, transfer of the required percentage of the outstanding debt to the sinking fund will be in effect after FY 1986; the national government will transfer to local governments 32 percent of national income, corporate and liquor taxes, which are expected to increase at the nominal rate of economic growth of 6.5 percent with an income elasticity of 1.2; overall tax revenues are based on nominal economic growth of 6.5 percent and an income elasticity of 1.1; and deficit bonds will be reduced by Y1,150 billion annually after FY 1986.

Source: Ministry of Finance

Table 6: Medium-Term Budget Projection, FY 1985-FY 1989

(in billions of yen and percentage change)

	FY 1985		FY 1986		FY 1987		FY 1988		FY 1989	
Payments										
Debt Service	Y10,224.1	11.7%	Y11,319.5	10.7%	Y13,920.0	23.0%	14,540.0	4.5%	Y15,070.0	3.6%
Transfers to Local Governments	9,690.1	9.0	10,185.0	5.1	10,800.0	6.0	11,640.0	7.8	12,550.0	7.8
General Expenditures	32,585.4	-0.0	32,584.2	-0.0	33,830.0	3.8	35,240.0	4.2	37,650.0	6.8
					[34,340.0	5.4	36,300.0	5.7	39,340.0	8.4]
Current Expenditures	24,951.3	1.2	25,214.1	1.1	26,380.0	4.6	27,710.0	5.0	30,030.0	8.4
					[26,780.0	6.2	28,540.0	6.6	31,380.0	10.0]
Capital Expenditures	7,634.1	-3.7	7,370.1	-3.5	7,450.0	1.1	7,530.0	1.1	7,620.0	1.2
					[7,560.0	2.6	7,760.0	2.6	7,960.0	2.6]
Total Payments	52,499.6	3.7	54,088.6	3.0	58,550.0	8.2	61,420.0	4.9	65,270.0	6.3
					[59,060.0	9.2	62,480.0	5.8	66,960.0	7.2]
Receipts										
Tax Revenues	38,550.0	11.4	40,560.0	5.2	43,120.0	6.3	46,200.0	7.2	49,500.0	7.2
Non-tax Revenues	2,269.6	-32.3	2,582.6	13.8	2,360.0	-8.6	2,510.0	6.5	2,670.0	6.5
Government Bonds	11,680.0	-7.9	10,946.0	-6.3	9,640.0	-11.9	8,330.0	-13.6	7,020.0	-15.7
Deficit Bonds	5,730.0	-11.2	5,246.0	-8.4	3,940.0	-24.9	2,630.0	-33.2	1,320.0	-49.8
Construction Bonds	5,950.0	-4.4	5,700.0	-4.2	5,700.0	0.0	5,700.0	0.0	5,700.0	0.0
Total Receipts	52,499.6	3.7	54,088.6	3.0	55,120.0	1.9	57,040.0	3.5	59,190.0	3.8
Shortfall (Total Payments minus Total Receipts)	--	--	--	--	3,430.0	--	4,380.0	--	6,080.0	--
					[3,940.0	--	5,440.0	--	7,770.0	--]
Current Expenditures	--	--	--	--	3,320.0	--	4,200.0	--	5,850.0	--
					[3,720.0	--	5,030.0	--	7,200.0	--]
Capital Expenditures	--	--	--	--	110.0	--	180.0	--	230.0	--
					[220.0	--	410.0	--	570.0	--]

Note: Figures in brackets allow for new stimulative spending.

Assumptions: For debt service costs, transfer of the required percentage of the outstanding debt to the sinking fund will be in effect after FY 1987; the national government will transfer to local governments 32 percent of national income, corporate and liquor taxes, which are expected to increase at the nominal rate of economic growth of 6.5 percent with an income elasticity of 1.2; overall tax revenues are based on nominal economic growth of 6.5 percent and an income elasticity of 1.1; deficit bonds will be reduced by Y1,310 billion annually after FY 1986; and issuance of construction bonds will be kept at the FY 1986 level.

Source: Ministry of Finance

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What The Numbers Don't Show

Under Secretary of State for Economic Affairs Allen Wallis recently reiterated the administration's position on U.S.-Japan relations in a speech before the U.S.-Japan Economic Agenda in Washington. If there were any doubts about Washington's approach in dealing with its Pacific ally before the Tokyo summit talks, Mr. Wallis' speech certainly dispelled them. Warning against the

Y3.3 trillion ($19.4 billion at Y170=$1.00), the yen's appreciation will reduce it by Y4 trillion ($23.5 billion).

Randall S. Jones

Japanese Wage Increases Fall Short Of Last Year's Hikes

The annual spring round of industry-wide wage negotiations in Japan has yielded lower wage offers than last year despite government support for a substantial increase to stimulate consumer spending. Surveys of firms and unions indicate that wages will increase about 4.6 percent compared to slightly over 5 percent last year. The smaller increase reflects the depressing effect of the stronger yen on the Japanese economy.

Most labor unions had called for a wage hike of at least 7 percent as compensation for a succession of small increases in the past (see JEI Report No. 14B, April 11, 1986). During the last five years, the manufacturing sector's productivity has increased 25 percent while real wages have risen only 11 percent. Management, however, countered that the increase should be limited to 3 percent, citing the decline in corporate profits in fiscal 1985 for the first time in three years.

The All-Japan Council of Private Sector Labor Unions predicts that wage increase in the private sector will top 4.6 percent, less than 1985 but higher than 1984's 4.46 percent rise. A survey of 681 firms by Nihon Keizai Shimbun forecasts a 4.51 percent wage increase (see Table). Service sector workers are generally expected to fare better than those in manufacturing, although only two industries, information processing equipment and services and retailing, are likely to exceed the 5 percent level. Last year, in contrast, seven industries topped 5 percent. Moreover, information processing equipment and services is the only industry that is likely to grant a larger wage increase in 1986 than in 1985.

Steelworkers, traditionally the pacesetters in wage negotiations, fared poorly once again this year. From 1981 through 1985 this group's average wage increase was only 4.7 percent, compared to 5.7 percent for the private sector as a whole. This year Japan's top five steel makers agreed on a wage hike of only 2.66 percent, their smallest raises ever. The firms had earlier cut salaries for senior executives because of poor earnings and forecasts that this year's total crude steel output will be less than 100 million metric tons.

The wage increase for public corporation employees, such as postal workers and Japanese National Railway employees, is 4.28 percent, compared to 4.85 percent last year. From 1981 to 1985, these workers averaged 5.6 percent wage hikes, nearly matching the private sector's 5.7 percent.

The moderate wage gains from this year's negotiations are unlikely to provide a major boost to personal consumption expenditures, which registered a modest inflation-adjusted rate of 2.7 percent in 1985 while the economy grew 4.6 percent in real terms. But inflation, which was only 1.9 percent last year, is expected to decline further because of the stronger yen. It is likely, therefore, that 1986's real wage increase should at least match or exceed last year's rise.

Randall S. Jones

Japanese Wage Offers For 1986*

(average monthly wage increase in yen)

Industry	Actual Results 1985		Projected Results 1986		New Monthly Standard Wage
All Companies	Y10,922	5.12%	Y9,974	4.51%	Y220,846
Large Companies	10,924	5.12	9,979	4.51	220,969
Small Companies	10,677	5.39	9,273	4.57	202,862
Manufacturing Sector					
Information Processing Equipment and Services	12,481	5.68	13,262	5.70	232,283
Electronics/Electrical	10,719	5.48	9,693	4.80	201,700
Energy-Related	11,323	4.81	11,479	4.74	242,119
Food Products	10,882	4.84	10,796	4.65	232,058
Motor Vehicles	11,020	5.45	9,733	4.63	210,155
Transportation	11,644	4.96	10,943	4.52	242,120
Nonelectric Machinery	11,839	5.37	10,115	4.44	227,336
Textiles/Paper	10,046	5.19	8,734	4.36	200,080
Chemicals	11,083	4.81	9,594	4.03	237,902
Metals	9,052	3.98	6,396	2.72	234,725
Shipbuilding/Defense	9,022	3.97	5,774	2.45	235,139
Service Sector					
Retailing	9,495	5.20	9,675	5.10	189,642
Services/Leisure	11,614	5.35	11,223	4.98	225,308
Construction	11,147	4.65	10,472	4.25	245,978

*Based on offers and settlements by 681 companies as of April 11, 1986.

Source: Nihon Keizai Shimbun, April 16, 1986.

Tax Reform In Japan Shows Some Life

The consensus-building process on tax reform is showing renewed signs of activity, in large part due to the expected Diet elections this summer. Two important advisory bodies have sketched out a major income-tax reform program, paving the way for discussion of the details. At the same time, other private-sector and government bodies are advocating further changes in tax regulations applicable to savings and fuels. Whether these developments will truly get the ball rolling in time for enactment at the beginning of fiscal 1987 (April 1, 1987) is still unclear.

The Liberal Democratic Party Tax System Council released an interim report April 24 calling for cuts in both personal and corporate income-tax rates as one part of the fiscal 1987 reforms. This advisory board reflects a wide range of opinions and gives a good indication of feelings among the rank and file. Although the report is decidedly lacking in specifics, it discusses three main proposals: tax simplification through an unspecified reduction in the number of tax brackets for individuals (currently 15); a reduction in the

Mexico Seeks Help From Japan

The sharp decline in crude oil prices has helped some countries and hurt others. Japan will certainly benefit from cheaper oil due to its high dependence on imported crude. Mexico, on the other hand, has seen its export earnings shrink dramatically in the past few months and officials see no sign of a reversal. This development poses a serious threat to the entire Mexican economy in light of the country's large foreign debt. Since Japan is flush with savings, it is not surprising that there have been domestic and foreign calls for Japan to lend Mexico a bigger helping hand.

Japan runs a trade deficit with Mexico (see Table). The importance of oil in the trade picture is obvious, giving rise to Mexican concern over declining prices. Japan's deficit with Mexico fell 36.2 percent in 1985 compared with the previous year, in large part due to the 17.3 percent decline in the value of oil purchases. Also of concern are the drops in imports of Mexican-produced food products, textile inputs, metal ores and chemicals, while exports of Japanese manufactured goods continued to grow.

Japan's Trade With Mexico, 1984-85

(in millions of dollars)

	1984	1985
Exports		
Food	$0.4	$0.2
Textiles	3.0	4.4
Chemicals	23.1	31.4
Nonmetallic Mineral Manufactures	3.2	5.4
Metals and Metal Products	159.6	126.9
Machinery	672.0	782.5
Other	26.6	43.2
Total	887.9	994.5
Imports		
Food	79.9	59.8
Textile Materials	64.6	26.3
Metal Ores	37.1	28.9
Mineral Fuels	1,787.4	1,479.0
Other Raw Materials	78.0	84.1
Chemicals	56.7	49.1
Machinery	27.8	35.4
Other	128.3	107.3
Total	2,259.8	1,869.9
Balance	-1,371.9	-875.4

Source: Japan Tariff Association, The Summary Report: Trade of Japan

Against this background, Mexican Finance Minister Jesus Silva Herzog visited Japan April 21-25 seeking aid. Mr. Herzog said that his country faced a $6-$8 billion decline in export earnings this year due to lower oil prices, complicating the repayment of over $98 billion in foreign loans that had accumulated by the end of 1985. He prodded the government and private sector to invest at least $1 billion in Mexican development projects over the short run, stressing Mexico's proximity to the United States and low labor costs. Because Japan benefits greatly from lower oil costs, he urged that Tokyo return some of those gains to poor countries like Mexico. The finance minister also sought more cooperation on preferential treatment for Mexican exports.

Government officials have been discussing an appropriate role for Japan in alleviating the debt crisis and have consistently pushed the topic during talks with other industrialized nations. They are well aware of the dangers of default, particularly the impact on U.S. banks. Mr. Herzog received a friendly reception, therefore, although no specific commitments were made. Nevertheless, it is very likely that investment money will flow in greater amounts from Japan to Mexico in the coming year.

Jon Choy

SDI Delegation Submits Report

The most recent Japanese delegation charged with reviewing policy options regarding Japanese participation in the Strategic Defense Initiative recently completed a 10-day tour of American research facilities and submitted its report to top cabinet officials, bringing a final decision on participation one step closer.

Japanese press reports suggest that the preliminary recommendations contained in the report favor SDI participation, although the nature of the proposed involvement remains unclear. Delegates appear convinced, however, that SDI participation would strengthen Japan's technological base and would not drain valuable resources, an important factor in making a final determination. The delegation presented only a summary of its lengthy report, which will be submitted to the cabinet before the Tokyo summit.

Almost a full year has passed since the Department of Defense invited U.S. allies to participate in the controversial research and development program. Of the countries that have indicated support or interest in SDI, Japan's investigation has been the most methodical. Tokyo is weighing a variety of political considerations, including the impact of participation on relations with other nations in the region; the policy ramifications given domestic restrictions on defense policies; and the lack of uniform support for the program in Tokyo's policymaking circles. The most recent delegation is the third group to have met face-to-face with American policymakers on SDI issues and the first to have actually toured U.S. facilities involved in research on the program. In some respects, it was considered the most important since it included private-sector technical specialists capable of making value judgements about the program's potential impact on Japan's scientific and technological base.

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JAPAN AND THE UNITED NATIONS

Summary

The United Nations has for many years been integral to Japan's concept of international relations, yet in pragmatic terms, the U.N. represents a consistent challenge to Japanese diplomacy. In order to maintain a moderate, non-controversial position on the conflicts played out there, as well as cope with the fluidity of world affairs, flexible responses are required; this style does not come naturally to practitioners of Japanese multilateral diplomacy. Recent events indicate, however, that Japan may be moving away from its traditional caution and toward the front lines of decisionmaking and leadership. Whether this policy direction can be sustained in such a hothouse of international opinion is doubtful, given various structural factors.

Troubled Beginnings

Japan's first experience with the international society concept was traumatic. Following the invasion of Manchuria in 1931 and various unsuccessful attempts to curb Japan's activities in China, Tokyo withdrew from the League of Nations in 1933. The League was ineffective in dispute settlement, bore no authority to enforce its decisions and never achieved full world organization status since the United States -- and until 1934 the Soviet Union -- were not members. But despite these drawbacks, many in the diplomatic community had supported Japanese involvement, and self-imposed isolation seemed a bitter choice. Exit from the League, as one participant called it, marked the beginning of an isolationist foreign policy that ultimately "spelled self-destruction" for Japan.

Primarily due to the reverberations of the East-West conflict, re-entry into the new international regime following World War II proved to be unexpectedly difficult as well. With a "peace" constitution and strong sentiments of neutralism and "ultrapacificism," Japan's leadership set about making peace with the world, culminating in the San Francisco Peace Treaty in 1951. After its acceptance into several U.N. agencies, in June 1952 Japan applied for U.N. membership.

Blocked by Soviet intransigence, though, admission was still four years away. Membership applications were subject to a Security Council vote, and the Soviet Union repeatedly vetoed Japan's entry. Soviet objections ostensibly focused on Japan's weak commitment to peace. Moscow also cited the continuing state of war between Japan and the U.S.S.R. and China (because these two nations had not entered into the San Francisco Treaty), the occupation of Japan by foreign forces, Japan's alleged lack of sovereign status, and its provision to the United States of a military base during the Korean conflict.

To offset the Soviet position, the United States pushed through the General Assembly a resolution recognizing Japan's qualifications for membership. U.S.-U.S.S.R. tradeoffs over new members postponed real consideration of Japan's membership until 1955, when a consensus was reached to admit a group of some 18 states en bloc. But Japan's admission came undone again when Nationalist China vetoed the Soviet-proposed candidacy of Outer Mongolia and the Soviets retaliated by blocking Japan's entry. It was only after the conclusion of negotiations with the U.S.S.R. to end the state of war and normalize relations in October 1956 that Japan, through some hard bargaining, won Soviet support on the U.N. issue. Japan became the 80th U.N. member on December 18, 1956, following unanimous votes in both the Security Council and the General Assembly.

Sources of Japan's U.N. Policy

To understand Japan's policies and practices in the U.N., it is important to focus on four main constraints on its activities: the domestic political setting, patterns in international relations, diplomatic style and organizational problems.

The Domestic Setting - The U.N. concept is important to Japan in both a formal and popular sense. For over 30 years it has been a highly visible priority of Japan's international diplomacy to be a fully integrated participant in the U.N. General Assembly and the specialized agencies. In fact, the organization's underlying philosophy holds such importance for Japanese theory and practice in the international arena that the precepts of the U.N. charter have been incorporated in descriptions of the country's international goals. Japan seeks to emphasize the preservation of world peace through efforts to contribute to political stability, economic development and dispute settlement. It sees these goals, elucidated in the U.N. charter, as being facilitated through participation by all nations in the U.N.

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The so-called U.N. first principle was for many years a stock feature of Japan's diplomatic "Blue Books," and, for similar reasons, the U.N. is a primary component of the multi-faceted comprehensive security approach adopted formally by the Japanese government in 1980. This followed Japan's Basic Policy for National Defense, formulated in 1957 and still officially in place, which describes U.S.-Japan security relations as temporary "pending the effective functioning of the United Nations in the future in deterring and repelling [external] aggression."

On a grass-roots level, the organization is still considered an arm of international peace and cooperation. Until very recently, public opinion polls in Japan verified that the man on the street had generally positive, even sentimental, views about the U.N. A 1984 poll by the Prime Minister's Office indicated that almost 42 percent of those interviewed gave the U.N. high marks, while about the same number expressed some skepticism about the worth of its activities. In fact, the respondents indicated some support for increased Japanese participation in U.N. activities. Almost 46 percent approved sending non-military Japanese personnel to join U.N. peacekeeping forces -- a controversial issue that policymakers have continually put aside.

Analysts have attempted to explain Japan's increased participation in the international arena in the context of the attitudes of otsukai and katagawari. Most simply put, these terms mean adopting international conduct in response to the expectations of foreign countries, and taking over the responsibility of maintaining international structures as the United States backs away from them. The combination of acting under pressure from outside forces and stepping into a more assertive leadership role as the United States withdraws is a foreign policy challenge readily acknowledged by Japan's leadership and widely debated in popular forums.

Understanding these principles makes the present situation easier to understand. Most observers agree that Japanese officials are reassessing the U.N. and Japan's role in it. Some analysts even go as far as calling it a crisis for Japanese multilateral diplomacy. The U.N.'s role in international political and economic activity seems increasingly limited, primarily since the organization is no longer seen as handling frontline issues. There is a marked tendency in Tokyo to devote the country's resources to bilateral matters, growing out of an awareness that this kind of international activity is more pressing and usually more productive than multilateralism. Furthermore, an increasing proportion of multilateral concerns today focuses on international finance and developing-country debt, and these issues are discussed and dealt with in other international agencies such as the Organization for Economic Cooperation and Development, the World Bank and the International Monetary Fund.

In more recent years Tokyo's official documents have placed less emphasis on the U.N., although the rhetoric used by officials and diplomats continues to publicly support and defend the high aspirations of the international organization and the basic principles of Japan's international goals. This trend has not gone unnoticed by critics in media and academic circles. Official policy toward the organization is also closely monitored by the parties that oppose the ruling Liberal Democrats. These groups have also challenged the perceived weakening of Japan's commitment to the organization.

If there has indeed been a backing away in doctrinal terms, many observers suggest that it represents a generally mature attitude among Japanese policymakers whose enthusiasm has been tempered by a hard-won realism, galvanized over the last several years, about the U.N.'s ability to achieve the lofty goals of world peace and prosperity.

In the realm of public opinion too, there is evidence that the U.N. and the idealistic principles associated with it have lost some of their attraction. Recent public opinion surveys indicate that the Japanese do not expect as much in the way of concrete action from the U.N. or its agencies as they once did, particularly vis-a-vis peace and security issues. A poll last year revealed, to policymakers' alarm, that the public support so long taken for granted may have eroded drastically and been replaced by a hard-nosed realism. Japanese respondents in the comparative survey expressed even more doubts about the U.N. than did their Western European counterparts -- who are usually considered skeptical or even cynical about the organization and its work.

Doubts about the U.N.'s administration and financing also contribute to the more critical attitude. The withdrawal of the United States and Great Britain from the United Nations Educational, Scientific and Cultural Organization (UNESCO) precipitated a close re-examination of Japanese motives for involvement in the U.N. and its associated agencies. Decisionmakers concluded that although leaving UNESCO would be easier than mounting a reform campaign, withdrawal would undermine fundamental Japanese diplomatic principles, enrage public opinion and contradict international pressures to become increasingly involved in global affairs.

It is against this backdrop that the administration of Prime Minister Yasuhiro Nakasone decided to bring Japan to the forefront of the U.N. and launch initiatives to bring about fundamental reform of the organization.

East-West, North-South - Japan's involvement in the U.N. has also been shaped by the two major conflicts of post-World War II international politics: the East-West confrontation in which Japan has sided with the United States and the North-South clash in which Japan has attempted to reconcile what are essentially unreconcilable stands on complex economic and ideological matters.

Three themes have characterized Japan's U.N. activities. From the first, Japan was openly aligned with the United States and defended U.S. leadership in the institution against challenges from communist and nonaligned blocs. A second thrust was a strong Asian identification and a determination to mediate between the developing countries and the industrialized nations of the West. Finally, because of its experience with atomic warfare, special attention was reserved for the issues of nuclear test bans and disarmament.

These policy priorities were frequently at cross purposes, as is evident from looking at Japan's issue management throughout three decades. On more strictly East-West issues like the admission of the People's Republic of China, Japan attempted to shadow the American line, although sometimes, as in the events surrounding China's acceptance in the early 1970s, Tokyo did not pick up on the rapid changes in Washington's position.

Japan's support for the United States implied voting with this country in crises like Hungary, Algeria, Cyprus, the Congo and the Middle East. However, in these situations Japan, as a member of what was then known as the

"Afro-Asian group" of developing countries, claimed to be representing the views of the newly emerging states against entrenched U.S. and European interests. As a result, it frequently ended up abstaining from votes or even voting against the so-called North in some of these cases.

Detente largely pushed superpower U.N. debates to the background. At the same time the North-South dialogue heated up. The growing discontent of the developing countries was galvanized during the early 1970s into a highly visible political push for global economic, social and cultural reform. In the hothouse atmosphere of the U.N., newly cohesive coalitions of developing countries, such as the Group of 77, were able to monopolize U.N. forums.

In economic and development affairs it was even harder for Japan to maintain its priorities. With prosperity Japan became associated with the positions of the industrialized nations in developing country perceptions. Indeed, when push came to shove, Japan more often sided with the United States and Europe on economic burden-sharing questions. Most crudely put, resource diplomacy -- the need to maintain good relations in order to secure raw material supplies and markets -- collided with basic commercial interests and attempts to preserve Japan's share of the world economy. The end result was indeed an example of otsukai -- a sense of being forced into participating in the overthrow of traditional financial and trade regimes that Japan supported and needed.

By separating rhetoric and practice, Japanese diplomats attempted to reconcile North-South antagonisms as well as promote Third World -- particularly Asian -- aims. As the dialogue gained in intensity, Japan tried to maintain support for such constructs as the New International Economic Order with its stipulations about world commodity pricing, eased debt payments, increased aid and technology transfers, and new economic regimes such as the U.N.-sponsored Law of the Sea treaty conference. But intent and actual practice veered in different directions in the attempt to cope with these stiff demands.

The end result was conciliatory posturing but little concrete support. This is not to say that the North-South dialogue did not spark change in Japan's policy; in fact, the U.N.'s impact on Japan's overseas development assistance programs has been noteworthy in terms of targets, terms and methods adopted. However, close study of Japanese participation in specific U.N. conferences, such as meetings of the U.N. Council for Trade and Development (UNCTAD) or the U.N. Industrial Development Organization (UNIDO), reveals the difficulties of combining sympathy for the arguments of the South with a defensive, risk-avoiding posture. This squashed Japan's chance to become an effective player in these forums.

The only area where Japan faced little challenge was nuclear disarmament. Indeed, Japan's promotion of nuclear test ban agreements and nuclear non-proliferation arrangements are a highlight of its U.N. participation, particularly during the first half of the 1960s. However, this support did not spill over into other war and peace issues. Due to the constitutional ban on military activities in foreign nations, the assistance Tokyo could offer to periodically formed regional U.N. peace forces was limited. Ultimately, financial contributions were sanctioned, although the provision of personnel, in any capacity, remained off-limits. Despite this compromise, Japan has been continually criticized by all parties for not providing adequate support to these peacekeeping forces.

Diplomatic Style - Diplomatic style has been one of the major constraints on Japanese activity in the U.N. Japan's international role has traditionally been considered reactive and passive; it is seen as avoiding confrontation, commitment or leadership in international meetings and organizations. In order to understand this characterization, it is necessary to examine Japanese diplomatic behavior, in addition to the entanglements of domestic politics and stated policies.

As described in the works of Michael Blaker and Haruhiro Fukui, among others, Japan's negotiating behavior is characterized by a defensive approach, with a marked preference for behind-the-scenes maneuvering, a penchant for meticulous planning and a distaste for premature commitment. The difficulty of maintaining this rather static, inflexible posture is compounded by the fact that Japanese diplomats feel tied to their initial diplomatic programs, attempt to avoid the appearance of being overly influenced by more powerful countries, and face great uncertainty from a lack of clear objectives.

Diplomatic positions, by design, are conceived and studied in Tokyo, where internal and external pressures are sorted out. After a position -- or in some cases a non-position -- is forged, diplomats are given their instructions. Individual representatives rarely have the authority to bargain on Japan's behalf, and if that kind of discretion is granted, parameters are set. Thus, when negotiating conditions change rapidly, Japanese representatives are forced to take vague, frequently indecipherable positions.

Decisionmaking in the U.N. forum calls for a flexibility that is usually not available to Japanese diplomats. As Michael Blaker in his classic study of Japanese negotiating style noted, there is

> credence to claims that Japanese diplomats are uncertain and hesitant in rapidly shifting multilateral negotiating situations. The persistent Japanese sense of insecurity in such circumstances make them appear defensive, stubborn and intransigent. Moreover, their hesitancy complicate[s] any attempt to orchestrate the complex forces that influence the bargaining process on the conference level.

Case studies of Japanese multilateral activity reveal that what has by now become a stereotype about the nation's behavior in international forums holds true. For example, largely due to the above characteristics, Japan was unable to participate effectively in one of the most important international integration schemes ever sponsored by the U.N., the Law of the Sea Conference. Although Japanese delegations were closely involved in all aspects of the long negotiating process, experts claim that there is no demonstrable connection between Japan's proposals and the final agreement. Handicapped by their diplomatic style and traditions, Japanese delegates were unable to achieve solid results despite their efforts.

The North-South confrontation provides ample examples of Japan's diplomatic style. Its decisionmaking process, faced with the onslaught of

Third World criticism, was consistently reactive rather than initiatory. Moreover, a lack of monitoring and decisiveness by Tokyo led to an uncertain negotiating behavior that was usually inconsistent and sometimes so vague that it was incoherent.

In these cases cultural elements contributed to the dilemma. However unhelpful they seemed to be, Japan's representatives, in rhetorical terms at least, saw themselves as supportive of the developing countries' cause and most of the world integration schemes discussed at that time. In an emotional, almost mystical, sense, Japanese diplomacy reflects a strong identification with Asia and a determination that Japan's special place as an Asian developed country empowers it to bridge the gaps between North and South. Despite the realities of the Japanese position, and even in the face of hopelessly deadlocked discussions, Japanese delegates seemed to believe that they could play a catalytic role between North and South and bring a more constructive tone to relations, or, in the words of foreign affairs wiseman Saburo Okita, seek out "new ways and philosophies" of economic cooperation.

This conviction may seem idealistic, but it grows out of a long-held concept that Japan could serve as a role model of economic growth for all developing countries, and for Asia in particular. However, in order to protect its own interests without alienating the developing countries, cautious behavior seemed imperative. The idea that Japan would have to be responsive but careful on development issues is seen in this quote from diplomatic historian Kajima Morinosuke:

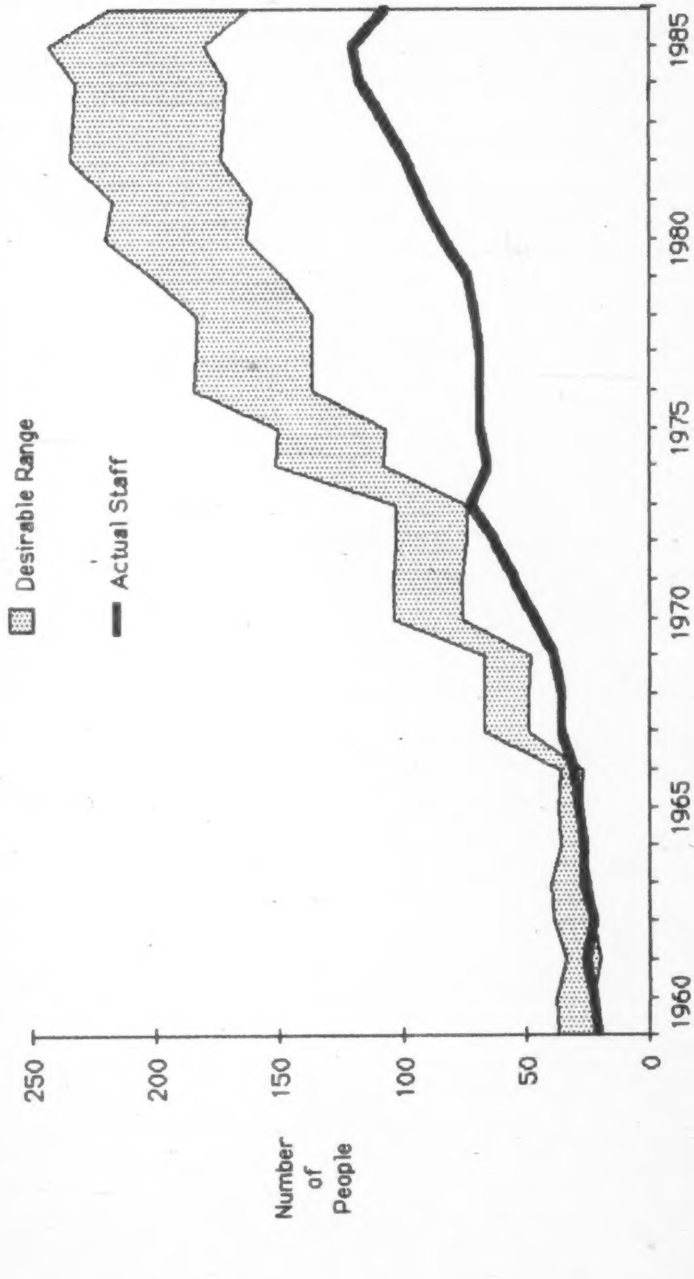
> . . . it is vitally important that Japan's diplomacy should be fully cognizant of the fact that the nations of Asia are intently watching Japan, trying to emulate her remarkable achievements in economic and other fields. It, therefore, must serve as a guidepost for the free countries of Asia, endeavoring at all times to avoid irrevocable diplomatic blunders on the international scene.

Organizational Constraints - Personnel and staffing problems present another major constraint on Japan's effectiveness in the international body. Successful involvement in the U.N. entails more than the ability to debate the issues; technically trained and politically astute international bureaucrats are required to administer U.N. programs. If a country is to have an impact at this level, the group must also provide patronage for new entrants into the system in order to bypass the barriers put up by the political and national cliques that have developed over the past 40 years.

For almost as long as Japan has participated in the U.N., it has been under-represented in terms of professional staff (see Chart). There are several reasons for this, including the fact that Japan is a relatively new member of the organization and missed out on the initial allocation of responsibilities; even now, the number of personnel slots assigned to Japan is not proportional to its relative financial support.

Moreover, Japanese personnel turnover is extremely high -- second only to the U.S.S.R. and the Eastern Bloc countries. This is due to several factors. About half of the country's U.N. appointees come from the Foreign Ministry or other government agencies. These bureaucrats are usually sent out

Japan's U.N. Secretariat Staff, 1959-86



Source: U.N. Secretariat, Office of Personnel Data.

for two- to four-year tours and then cycled back to other positions. The distinct paucity of career U.N. employees can be partially attributed to the fact that salary levels and benefits are generally uncompetitive with those available to young professionals in Japan. There is also a limited pool of applicants because of the language barrier and the small proportion of Japanese with graduate degrees.

And there is the sociological or cultural element. Contracts for U.N. appointments are generally short term at the outset, with an understanding that a career appointment will follow. The security that Japanese employees expect, particularly young professionals beginning their careers, is necessarily absent. Despite recruitment drives specifically aimed at Japan, and an abortive attempt in 1979-80 to simulate Japanese-style employment security by suspending usual personnel practices and giving Japanese nationals special probationary appointments, little headway has been made.

Although the greatest proportion of recruitment spending still goes to finding Japanese nationals, the special contract arrangment was terminated after charges that it was unfair to job-seekers from other nations. "The major reason we make no progress," says one U.N. recruitment officer, "is that the institutional sense of commitment to the employee isn't there, and the uncertainty isn't appealing to the Japanese, especially the young people."

Japanese representation among U.N. staff may be smaller than it could be, but no one is complaining about quality. The group of 107 in the U.N. Secretariat (ranked fifth in number of staff by nationality) is distributed fairly evenly among the various political, economic, administrative and technical functional areas. Despite the high turnover rate, some have risen to positions of authority; the under secretary for public information is a Japanese national. Japan ranks approximately tenth in the number of staff employed by the U.N. Development Program (UNDP) and U.N. International Children's Fund (UNICEF). Japanese also make up the third-largest nationality group in the U.N. Fund for Population Activities (UNFPA). These three agencies receive the biggest share of Tokyo's voluntary U.N. contributions.

The Benefits of U.N. Participation

Despite these difficulties, Japanese officials consider the U.N. a valuable forum from which to validate and reaffirm fundamental policies such as comprehensive security. Japan can answer criticism about its international responsibilities by pointing to its activities in the U.N. And there are opportunities to exploit the international organization in other ways to achieve other diplomatic goals.

A good example of all these elements is the periodic gathering of world leaders in New York. Annual addresses at the General Assembly opening in September are now customary for Japanese foreign ministers. When the celebration of the U.N.'s 40th anniversary took place in October 1985, both Prime Minister Nakasone and Foreign Minister Shintaro Abe gave addresses outlining Japan's international policies and priorities and reiterating Tokyo's commitment to play a larger role in global affairs. Both Mr. Nakasone and Mr. Abe also used the anniversary celebration to further bilateral aims with both close friends and estranged nations. Mr. Abe was able to set in motion a visit to

Japan by Soviet Foreign Minister Eduard Shevardnadze during his stay in New York (see JEI Report No. 38B, October 4, 1985, and No. 42B, November 1, 1985).

And there is the all-important question of international prestige. Despite the realities of day-to-day international trade-offs, Japan has always wanted to be recognized as an important country in a titular sense. The search for prestige continues, as seen in Japan's pursuit of a wider role at summits and other international meetings. In the case of the U.N., Japan also has ambitions. For many years Tokyo placed great emphasis on securing a permanent seat on the Security Council, convinced that its role would be limited without permanent access to this powerful decisionmaking body. From time to time Japan has been elected to the non-permanent seat allocated to Asia, most recently during the 1981-82 session. Efforts to gain a seat are still a Japanese goal. However, Security Council membership would require a change in the U.N. charter, and Japanese diplomats concede privately that it is not a realistic or high priority proposition.

New Approaches: New Activism?

There is evidence that Japan's approach toward the U.N. has matured, particularly in the last five years as the pressures of the Third World economic agenda have eased. The need to deal with various problems facing the organization has stimulated the new approach, as well as precipitated a tentative new activism in Japan's policy.

Because the Soviet Union and Eastern European states have withheld their contributions and the United States has drastically cut its support payments, the U.N. has come under severe financial strain, with a budget shortfall of approximately $240 million in 1985. Poor management has only exacerbated the problem. Japan, currently the second-largest U.N. contributor (see Table), has come under increasing pressure to take up the slack.

In previous financial crises Japan did not question the U.N.'s management and continued its contributions unabated. Now, say diplomats, Japan is demanding that the Secretary General address the fundamental problems precipitating the present crisis. A quick fix is unacceptable and Tokyo has said it will not approve increases in voluntary contributions until the matter is resolved.

When the United States withdrew from UNESCO in 1985 on the grounds that the organization was mismanaged, blatently politicized and anti-Western, the United Kingdom followed suit. Japanese policymakers, however, while acknowledging UNESCO's problems, have eliminated withdrawal as too drastic and opted for a policy of reform from within, fully understanding that this implies an unprecedented activism.

A major manifestation of this approach has been the decision to sponsor a plan to initiate a comprehensive review of U.N. administrative, budgetary and financial matters. First proposed by Foreign Minister Abe in September of last year, the idea centers around the appointment of an 18-member group of intergovernment experts to begin the reform process. Following a great deal of political compromise, which Japanese sponsors handled with agility, the resolution to establish the expert group was adopted by the General Assembly December 19.

Top Contributors to the United Nations Organization, 1982-84

(in millions of dollars)

	1982			1983			1984		
	Assessed	Voluntary	Total	Assessed	Voluntary	Total	Assessed	Voluntary	Total
United States	$520.0	$481.4	$1,001.3	$407.3	$463.5	$870.7	$450.2	$500.6	$950.8
Japan	162.9	231.2	394.1	172.2	240.3	412.5	168.3	193.0	361.4
West Germany	142.3	127.7	270.0	144.0	109.9	253.8	138.3	114.5	252.8
Italy	63.0	84.2	147.3	62.2	102.7	164.9	61.8	115.5	177.3
Canada	57.6	100.4	158.0	54.3	116.4	170.7	50.7	124.6	175.4
Great Britain	82.9	87.1	170.0	83.9	80.5	164.3	78.6	91.4	169.9
Soviet Union*	148.4	13.1	161.5	173.0	12.7	185.7	151.5	13.2	164.7
France	113.5	42.3	155.8	123.5	46.7	170.2	112.9	47.1	160.1
Sweden	23.5	118.3	211.7	21.8	148.2	169.9	23.1	135.7	158.8
Netherlands	28.4	169.6	198.0	29.2	135.1	164.3	29.7	117.5	147.3
All Contributors	1,709.8	2,301.2	4,011.0	1,669.1	2,203.6	3,872.7	1,621.9	2,225.5	3,847.4

* The Soviet Ukraine and Byelorussia are included in this figure.

Note: Assessed Contributions include funding for the U.N. Secretariat as well as the U.N. Emergency Force/Disengagement Observer Force, U.N. International Forces in Lebanon, International Labor Organization, Food and Agriculture Organization, U.N. Educational, Scientific and Cultural Organization, International Civil Aviation Organization, World Health Organization, Universal Postal Union, International Telecommunications Union, World Meteorological Association, International Maritime Organization, World Intellectual Property Organization and International Atomic Energy Agency.

Voluntary Contributions include support for the U.N. Forces in Cyprus, U.N. Industrial Development Organization, U.N. Environment Program, U.N. Center for Human Settlements, U.N. Children's Fund, U.N. Development Program, World Food Program, U.N. High Commissioner for Refugees, U.N. Relief and Works Agency, U.N. Institute for Training and Research, U.N. Fund for Population Activities, and supplemental funding for ILO, FAO, UNESCO, WHO, UPU, IMO, WMO, WIPO, and IAEA.

Source: United Nations, Report by Committee on Contribution, Supplement No. 11, 1981/82 and 1983/84.

The Japanese delegation has now begun to formulate a follow-up plan. Assuming that the expert group will make a number of recommendations for submission by late summer, Japan's representatives will push for action on those changes around which a consensus has already been built, and will seek common ground on more difficult issues. The real action should begin with the new General Assembly session in September. Then the pressure and the spotlight, diplomats admit, will become increasingly uncomfortable and the test of Japan's initiative will begin in earnest.

There are differing viewpoints on whether the expert group proposal and the decision to spearhead U.N. reform mark a major step in the evolution of Japan's role in the organization. Most of the questions revolve around Japan's commitment to what on the surface appears to be a strong involvement. The reform initiative indeed is an unprecedented step for Japan, but whether it is precedent-setting or not remains a serious question.

Diplomats portray the reform initiative as a test case for Japan's more assertive role. They describe the initiative as a case of the katagawari principle in action, reflecting the greater degree of involvement and responsibility that Japan feels for the U.N. now that the United States seems to be backing away. But, insiders say, Japan has serious obstacles to overcome. Inside the U.N., building coalitions and striking bargains will be exceedingly difficult -- and the legacy of Japan's passivity will be a great disadvantage.

A short list of Japanese anxieties focuses on the suspicions of developing countries that Japan may be changing the U.N. to suit itself -- or worse -- to suit its traditional mentor, the United States. Tokyo's intention, of course, is not to weaken the international organization, but to adjust it to changing needs and circumstances. According to a diplomat involved, getting that across will not be easy. "There is a perception among many delegations about how sincerely we're aiming for the improvement of the U.N.," he says, arguing that Japan's large and increasing contributions to the organization as well as the many times its positions have diverged from the Western line are not taken into account by developing countries.

In Japan there are also mixed feelings about the new approach. Although the Nakasone administration has placed considerable emphasis on the U.N., a politician in Japan cannot win an election simply by stressing prominence there. The constituency for U.N. activism is primarily a foreign one, and despite sentimental feelings about the organization, the public is not terribly interested in the details. Steady domestic political support, therefore, becomes uncertain.

Moreover, the shape of the next government is an open question. If Mr. Nakasone or Mr. Abe hold the leadership position, there is a greater chance for continuity in U.N. policy. Mr. Nakasone's opponents are aware of the benefits of the U.N. forum. For example, all the political parties and several LDP factions sent representatives to an arms control conference in 1983, but an activist role may be too closely associated with the present administration.

Moreover, resistance could very well come from within the Foreign Ministry. Many diplomats seem unconvinced that greater U.N. involvement is a high-priority foreign policy matter. The esoteric nature of much of the organization's activity seems irrelevant to international affairs. This brings up the question of whether Tokyo will be closely monitoring and supporting efforts by its New York delegation if the reform process does not run smoothly. If the lines of decisionmaking are tangled, the Japanese delegation will not be able to follow through with any kind of assertive approach.

"Cautious optimism" is how some American experts view Japan's newly prominent role. They stress that although the commitment level is high right now, it does not necessarily imply new leadership. Working within an institution to shape it or orchestrate the details of reform requires a set of goals, a vision of what shape the organization should take. Skeptics doubt that Japanese leaders or foreign policy specialists have thought that far ahead.

Looking Ahead

To predict Japan's future role in the U.N., it is necessary to take into consideration what the Japanese expect from the organization, as well as their willingness to develop new guidelines for behavior there. Withdrawing from the organization, for philosophical as well as historical reasons, is not an option. The Nakasone administration has chosen instead to take the offensive and attempt to initiate a review and reform of the administrative and financial problems facing the U.N. and its associated agencies. This adds institutional reform to the substantial list of issues to be managed there, including questions over Japan's financial contributions during the funding crisis, its participation in the U.N. peacekeeping forces, and the day-to-day challenge of maintaining good relations with both the United States and the industrialized West, and the developing countries.

The reform initiative may or may not indicate a new leadership role for Japan. Undercutting its attempt are lines of decisionmaking that hobble the ability of Japanese representatives to wage effective diplomatic battle. At the same time, there is a growing awareness that there are minimal diplomatic benefits and not much prestige to be derived from the U.N., shaky support from Tokyo, a host of bad perceptions about Japan's motives and intentions, and a need to develop a larger corps of experienced international functionaries willing to spend prolonged periods of time in the U.N. bureaucracy. Unless some extremely innovative solutions to these problems are found, it seems unlikely that Japan will be able to sustain a drive to the frontline of U.N. decisionmakers.

For further information, contact Sheri Hoptman.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

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JEI

REPORT

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Summit Attains Economic Heights

For a change, economic issues proved almost as tractable as political ones to the leaders attending the annual seven-nation economic summit in Tokyo. While a strong agreement on countering terrorism and improving nuclear power cooperation was grudgingly hammered out, a consensus on trade and monetary matters was more elusive. General support was voiced for several discussion topics that had arisen at earlier multilateral meetings, but to Japan's chagrin, conflict over the yen-dollar exchange rate developed. Nevertheless, the talks showed that the seven leaders were willing to consider a more coordinated approach to global economic problems.

Participants at the May 4-6 summit reaffirmed several previous commitments that had been discussed at the annual Organization for Economic Cooperation and Development meeting in April, including preparation for a new round of multilateral trade negotiations in September and developing rules for trade in services and other intangibles. Cautious steps were also made toward on a good show for the summit. Unlike his previous meetings with political leaders, Mr. Nakasone seemed to have no specific objectives for his own summit, with the possible exception of exchange rate stabilization. The implications of this approach are likely to be held against him by LDP rivals in the coming months. Even in the case of the yen-dollar exchange rate, critics will charge that the government would not have had to be concerned over stabilization if it had not blindly acquiesced to U.S. pressure to drive up the value of the yen.

It is unlikely that his summit performance will markedly damage Mr. Nakasone's standing with the voters. According to opinion polls released just prior to the seven-nation conference, respondents expected little in terms of concrete results from the summit. This will help prevent any residual damage to the LDP in the upcoming elections. The real problem facing Mr. Nakasone, however, is in the party's inner circles, where rivals who agreed to support the prime minister until the conclusion of the summit can be expected to remove their gloves for the succession battle that is expected to follow.

In fact, most of the leading contenders for his post may have suffered politically as a result of the summit. Finance Minister Noboru Takeshita can be expected to share the blame for the problems facing the yen, while Foreign Minister Shintaro Abe might come under criticism for the Libyan terrorism statement. Ironically, that leaves LDP executive council chairman Kiichi Miyazawa as the only major opponent of Mr. Nakasone who stands to gain from the summit.

Michael W. Chinworth

Forecasts For Japan's Economy Revised

The sharp rise in the value of the yen and the fall in oil prices have led many economists in Japan to revise their forecasts for the fiscal year that began last month. For the 15 major economic institutions shown in Table 1, the average real growth forecast is 3 percent, compared to the 3.1 percent prediction made last December. Four institutions, though, revised their forecasts upward, while four made no change, reflecting the uncertainty over the impact of the strong yen. All agree, however, that the strong currency, combined with falling oil prices, will increase the country's FY 1986 current account surplus by an average of $14 billion.

The beneficial effects of cheaper imported materials, lower interest rates and less expensive oil are expected to boost both inflation-adjusted consumer spending and business investment about half a percentage point to 3.4 percent and 5.2 percent, respectively. But on average, the forecasters expect that the deflationary effects of the strong yen will outweigh these benefits. Exports valued in yen, which fell in the last half of 1985, are expected to decline at least 6.5 percent this year according to a number of economists. In March exports registered a 2.1 percent decline in volume terms from the year-earlier level -- the first drop in 25 months.

There are other signs of weakness in the economy as well. The ratio of inventory to sales rose in March to its highest level since July 1982. Moreover, a survey by Wako Research Institute predicts a double-digit decline in profits for the second consecutive year, with net earnings down 14.8 percent in FY 1986 after a 19.7 percent drop last year. Fuji Bank, which forecasts only 2.2 percent real growth in FY 1986, believes the plunge in oil prices will have a negative effect on Japan's economy by lowering the value of companies' inventories.

Table 1: Revised Economic Forecasts For Fiscal 1986

(percentage change in real terms)

	GNP	Consumer Spending	Capital Spending	Current Account Surplus*	Y/$ Exchange Rate
Daiwa Securities Research Institute	4.3%	4.4%	6.1%	$70.7	Y188
Research Institute on the National Economy	4.0	3.3	4.9	77.7	180
Mitsubishi Bank	3.4	3.5	5.8	76.8	194
Nomura Research Institute	3.3	3.4	6.1	65.9	164
Sanwa Bank	3.0	3.7	5.4	73.7	180
Dai-Ichi Kangyo Bank	3.0	3.0	8.4	70.0	170
Long-Term Credit Bank of Japan	3.0	3.9	4.0	72.9	190
Wako Research Institute of Economics	3.0	3.6	5.5	73.7	180
Japan Economic Research Center	2.7	3.1	4.0	73.0	184
Nikko Research Center	2.7	2.9	4.7	77.3	180
Industrial Bank of Japan	2.7	4.3	5.1	72.4	180
Nippon Credit Bank	2.6	3.5	3.7	60.9	178
Sumitomo Bank	2.5	2.5	6.9	72.5	178
Fuji Bank	2.2	3.1	4.5	66.0	183
Nikkei Economic Electronic Databank System	2.1	3.5	3.5	58.5	175
Total Average	3.0	3.4	5.2	70.8	180

*In billions of dollars

Source: Japan Economic Journal, April 26

Other analysts, however, disagree. Minister of International Trade and Industry Michio Watanabe observed that "An oil price decline is never a negative factor for the Japanese economy." The average delivered price of oil in Japan in February was $27 a barrel, indicating that the benefits of cheaper oil are yet to be felt. The Research Institute on the National Economy predicts that lower oil prices will help the economy achieve the government's goal of 4 percent real growth. The institute expects domestic demand to account for 3.7 percentage points of growth, assuming an exchange rate of Y180=$1.00 and a further cut in the Bank of Japan's official discount rate to 3 percent.

The oil price decline, though, is likely to increase friction with Japan's trade partners by raising its FY 1986 current account surplus to about $70 billion, according to the consensus view of economic institutes. This forecast is based on an average exchange rate of Y180=$1.00, which already appears to be out of date, given the yen's rise to Y165.2=$1.00 on May 6.

The unexpected nature of the yen's recent surge is reflected in the long-range forecasts shown in Table 2. The yen has already passed the Y180=$1.00 level predicted for September 1986 and is approaching the 1989 forecast of Y159=$1.00. The forecasters do not expect Japan's current account surplus to recede quickly: they predict a surplus of $50.6 billion in FY 1989. This outlook assumes a discount rate of 4.2 percent, oil priced at $20.30 per barrel and 3.1 percent real economic growth in the United States.

Table 2: Long-Term Economic Forecasts

	Y/$ Exchange Rate		Current Account Surplus*	
	September 1986	March 1989	October-December 1986	FY 1989
Research Institute on the National Economy	Y180	Y150	$78.8	$51.0
Sumitomo Bank	175	160	74.0	70.0
Daiwa Securities Research Institute	185	150	67.5	25.0
Japan Economic Research Center	185	180	75.5	54.2
Industrial Bank of Japan	180	160	72.0	50.0
Long-Term Credit Bank of Japan	175	155	60.0	40.0
Nomura Research Institute	170	160	65.0	40.0
Mitsubishi Research Institute	175	160	65.0	45.0
Marubeni Corp.	185	160	76.0	65.0
Mitsui & Co., Ltd.	183	155	60.0	65.5
Total Average	180	159	69.4	50.6

*In billions of dollars at an annual rate. Midpoint given for range estimates.

Source: Japan Economic Journal, April 19, 1986

Randall S. Jones

Education Commission Releases Further Reform Recommendations

The prime minister's education reform committee has submitted a second set of sweeping recommendations to adapt the postwar educational system to the needs of the future. The commission's proposals largely conformed with its previous positions, including the expansion of continuing education courses to enable greater educational opportunities for adults, and prolonged probationary periods for newly hired teachers. The report emphasized the cultivation of individuality through broader flexibility for students in course selection, while maintaining traditional Japanese values in an international context.

STATISTICAL SUPPLEMENT

Trade and Payments Data
(in millions of dollars unless otherwise indicated)

	1984	1985	January-March 1985	January-March 1986	January 1986	February 1986	March 1986
Japan's Balance of Payments							
Trade Balance	$44,257	$55,986	$8,937	$14,593*	$2,386*	$4,784*	$7,423*
Exports (f.o.b.)	168,290	174,015	38,164	45,089*	12,723*	15,054*	17,312*
Imports (f.o.b.)	124,033	118,029	29,227	30,496*	10,337*	10,270*	9,889*
Current Account Balance	35,003	49,169	6,818	12,718*	1,878*	3,941*	6,899*
Long-Term Capital (net)	-49,651	-64,542	-10,355	-18,950*	-7,305*	-7,941*	3,704*
Overall Balance	-15,200	-12,318	-2,414	-5,695	-5,152	-1,299	756
International Reserves (end of period)	26,313	26,510	26,538	27,917	26,961	27,582	27,917
Japan's Customs Clearance Trade							
Trade Balance	33,611	46,099	6,016	12,475*	1,888	3,928	6,660*
Exports (f.o.b.)	170,114	175,638	38,510	45,502*	12,795	15,084	17,624*
Cars	21,899	25,402	4,561	6,517*	2,161	2,342	2,015*
Steel	13,852	13,566	3,269	2,867*	832	990	1,045*
Imports (c.i.f.)	136,503	129,539	32,495	33,027*	10,907	11,156	10,964*
Crude Oil	39,379	34,599	9,722	8,537*	2,691	3,299	2,547*
Japan-U.S. Trade							
Trade Balance	33,075	39,485	6,575	10,438*	2,903	3,729	3,806*
Exports (f.o.b.)	59,937	65,378	13,348	16,709*	4,957	5,735	6,017*
Imports (c.i.f.)	26,862	25,793	6,773	6,271*	2,055	2,005	2,211*
Yen-Dollar Exchange Rate							
Tokyo Spot Market (end of period)	Y251.10	Y200.50	---	---	Y191.80	Y179.70	Y179.60
U.S.-Japan Trade							
Trade Balance	-33,560	-46,152	-10,241	-14,374	-5,139	-4,048	-5,187
Exports (f.a.s.)	23,575	22,631	6,252	5,574	1,763	1,813	1,998
Industrial Supplies	9,139	8,680	2,435	n.a.	701	723	n.a.
Food and Feed	5,929	5,001	1,214	n.a.	426	395	n.a.
Capital Goods	5,627	5,939	1,736	n.a.	394	446	n.a.
Consumer Goods	1,476	1,416	368	n.a.	123	131	n.a.
Imports (Customs)	57,135	68,783	16,493	19,948	6,902	5,861	7,185
Automotive Products	18,477	24,980	5,381	n.a.	2,674	2,193	n.a.
Capital Goods	19,290	21,516	5,529	n.a.	1,363	1,839	n.a.
Consumer Goods	11,266	14,017	3,449	n.a.	2,097	1,158	n.a.
Industrial Supplies	7,276	7,035	1,866	n.a.	669	583	n.a.

*Preliminary

Japanese Economic Indicators

(percentage change from year-earlier period unless otherwise indicated)

	1984	1985	January-March 1985	January-March 1986	January 1986	February 1986	March 1986
Discount Rate (end of period)	5.0%	5.0%	5.0%	4.0%	4.5%	4.5%	4.0%
Outstanding Money Supply	7.8%	8.4%	7.9%	9.0%	9.0%	9.0%	9.0%
Industrial Production	11.1%	4.6%	6.3%	1.3%*	1.3%	0.9%	1.7%*
Manufacturing Operating Rate	7.3%	1.2%	1.9%	-1.4%*	-1.1%	-2.0%	-1.1%*
Number of Bankruptcies	8.8%	-9.7%	-9.5%	-10.8%	-13.3%	-11.3%	-8.0%
Residential Construction Starts	4.4%	4.1%	7.9%	5.5%*	9.5%	5.9%	2.1%*
Job Openings to Applications (ratio)	0.65	0.68	0.68	0.65	0.67	0.65	0.64
Nominal Wages	4.5%	3.5%	3.8%**	4.9%**	5.1%	4.8%	n.a.
Labor Productivity	9.9%	4.2%	n.a.	n.a.	n.a.	n.a.	n.a.
Wholesale Prices	-0.3%	-1.1%	0.8%	-6.4%	-4.6%	-6.3%	-8.1%
Consumer Prices	2.2%	2.1%	2.0%	1.4%	1.4%	1.8%	1.1%
Yen-Based Export Prices	0.6%	-1.4%	4.5%	-14.1%	-11.1%	-15.2%	-15.9%
Yen-Based Import Prices	-3.4%	-2.5%	2.9%	-21.8%	-13.8%	-19.7%	-31.7%

*Preliminary

**Through February of each year only.

For Japan's most recent GNP figures, see JEI Report No. 12B, March 28, 1986.

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REPORT

NO. 19A May 16, 1986

U.S. IMPORTS FROM JAPAN: A REVIEW OF 1985 SALES

Summary

Imports from Japan, which seemed to be on a runaway course in 1984, were reined in last year by the U.S. economy's paltry 2.2 percent inflation-adjusted growth. True, purchases climbed 20.4 percent to $68.8 billion, but this increase, however politically explosive, was still only half of 1984's. The big difference was the pace of capital spending. A driving force in the first two years of the current economic expansion, business investment in plant and equipment slowed to a crawl in 1985, capping deliveries of Japanese-made capital goods at $21.5 billion for an 11.5 percent gain. Moreover, with American industry operating well below capacity for much of last year, arrivals of intermediate goods went up just 2.7 percent to $7 billion. At the same time, though, the surprising durability of consumer spending meant 24.4 percent more consumer goods for a total of $14 billion. It also helped transform automotive products from 1984's import laggards to last year's pacesetters as purchases jumped 32.1 percent to $25 billion.

Import Profiles

Automotive Products - Measured by Detroit's traditional yardstick, 1985 was a banner year for American automotive manufacturers. Combined U.S. car and truck sales climbed 8.6 percent to 15,723,116 units, erasing the old record set in 1978 by a solid 316,011 vehicles. Total car sales topped the 11 million mark for the first time since 1978 and were the fourth highest on the books at 11,043,768 units. The clincher was the industry's balance sheet. Profits at

General Motors Corp., Ford Motor Co., Chrysler Corp. and American Motors Corp. added up to a staggering $8.3 billion, second only to 1984's $9.8 billion bottom line.

But these numbers do not tell the full story of Detroit's performance in the 1985 car market. Sales of domestic makes were only up 3.2 percent to 8,204,542 units, a mere shadow of the 17 percent gain posted in 1984. Worse, more than one-third of the quarter-of-a-million additional cars sold last year were assembled by Honda of America Manufacturing, Inc. or the two newest U.S. auto companies -- Nissan Motor Manufacturing Corp. U.S.A. and New United Motor Manufacturing Inc., the Toyota Motor Corp.-GM venture. In a double blow, the Big Three had to resort to cut-rate financing and other incentives time and again to keep sales on the upswing, while import dealers in major metropolitan areas were able to tack hefty markups on the top-selling Japanese models.

Frustration was an occupational hazard for auto industry executives regardless of nationality in 1985. In mapping out U.S. sales strategies for the April 1985-March 1986 period, Japanese car manufacturers proceeded under the assumption that the export controls that had played havoc with their American marketing plans for the previous four years would be lifted. At the eleventh hour, however, a wavering Tokyo opted to extend the restraints for a fifth year but to raise the export limit on sedans and hatchbacks from 1,850,000 units to 2,300,000, with comparable 24 percent-plus increases in the separate quotas on shipments of four-wheel-drive cars, station wagons and vans (to 113,000 units) and vehicles for sale in Puerto Rico (to 95,700 units).

Tokyo's attempt to navigate a middle course backfired on both sides of the Pacific. The hike in the shipment ceiling for the twelve months starting in April 1985 boosted U.S. calendar year purchases of Japanese-made cars 29.6 percent to 2,527,467 units valued at $16.2 billion, a politically damaging 31.4 percent bulge in the import tally. Adding fuel to the smouldering protectionist fires, sales of made-in-Japan cars, which had dipped in 1984, jumped 16.4 percent to a record 2,217,860 units and supplied 20.1 percent of the American market. Japanese government and industry spokesmen were quick to point out that this market penetration was still below 1980-83 levels, but all congressional supporters of U.S. auto industry protection saw was that Japanese exporters had added 1.8 points to their artificially depressed 1984 share.

While the Japanese government was trying to contain the fallout in the United States from its decision to raise the restraint level, it also had to contend with grumblings at home about how the extra sedan/hatchback quota was allocated. Roughly three-fifths of the 450,000-unit increase was earmarked for shipment by Japan's five smaller exporters, with the lion's share going to GM's two affiliates -- Isuzu Motors, Ltd. and Suzuki Motor Co., Ltd. -- and to Mitsubishi Motors Corp., which supplies Chrysler. This formula left some 185,000 cars for distribution among Toyota, Nissan and Honda -- enough to build skimpy U.S. inventories to levels that supported expanded sales in 1985 but not as many cars as corporate planners for the three import leaders projected their companies could sell.

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Still hamstrung in their ability to supply U.S. demand, Japanese car makers continued the profitable move into the midsize and luxury markets that are Detroit's mainstay. For Toyota this marketing strategy meant that the top-of-the-line Cressida and Camry models generated 28 percent of 1985 sales, which came to 620,047 cars, compared with 23 percent of the year-earlier total of 557,981 units. Including the upscale Celica, Supra and new MR2 sports cars as well, fully one-half of the cars sold by the number-one importer last year fell into the midsize or luxury segments. Nissan used the same tactics in expanding sales 10.3 percent to 535,372 cars, with the high-end Maxima, 300 ZX and 200 SX accounting for 43.4 percent of this number. Honda's 1985 import sales of 406,413 units (up 8.4 percent) were split almost evenly between small cars and upscale models, but with access to nearly 150,000 Ohio-built Accords, it had a far more profitable product mix than either Toyota or Nissan.

Big margins on their 1985 car sales allowed Japan's motor vehicle makers to continue the expensive battle for position in the fast-expanding but fiercely competitive American small truck market. Sales of compact pickups, vans and sports-utility vehicles have skyrocketed since 1981, jumping 30.4 percent last year alone to 2,244,032 units. The increasing number of new vehicle buyers unwilling or unable to foot the $11,000-plus average cost of American cars or the equally stiff cost of Japanese models was one reason small truck sales broke records in 1985 for the fourth straight year. But a big part of the credit goes to Detroit for astute product development.

After conceding a growing share of light-duty truck sales to Japanese-made compact pickups in the late 1970s, GM, Ford and Chrysler jumped into the small truck market in late 1981-early 1982 with their own compact pickup models. The immediate success of these trucks, which had larger passenger and cargo compartments and better fuel economy than the imports but were competitively priced, encouraged GM, Ford and AMC to design a new lineup of downsized sports-utility vehicles. These vehicles, unveiled in 1982 and 1983, also won almost instant market acceptance. If initial sales figures are any indication, though, the minivans introduced by Chrysler in late 1983 and GM and Ford over the next two years could turn out to be Detroit's best-selling small truck products yet.

Japanese small truck suppliers pursued some familiar marketing strategies in the 1985 phase of their four-year sales battle with American manufacturers. Aggressive pricing remained the key weapon, as importers not only kept stickers on their price-leader pickup trucks below $6,000 for the fourth consecutive year but also held the pricing line on many of their more expensive models. Moreover, they continued to add new models to their lineups, devote a disproportionate share of automotive advertising budgets to trucks, and periodically offer low-cost financing and other sales incentives.

These tactics paid off in 1985's strong U.S. small truck market. Combined sales of Japanese nameplates, which had soared 54.7 percent the year before, climbed an additional 24.4 percent to 808,529 units (including roughly 100,000 assembled by Nissan in Tennessee). In the process, imports ballooned 42 percent to 803,965 vehicles valued at $3.4 billion, a 45.1 percent gain. But these numbers were no match for the U.S. industry's results. American producers boosted sales of their innovative small trucks 34 percent to 1,435,503 units and trimmed the market share controlled by Japanese makes another 1.8 points to 36 percent.

Higher sales of American-built cars and trucks in 1985 gave another shot in the arm to beleaguered domestic suppliers of original equipment parts, but their problems were by no means behind them. For starters, U.S. car and truck production, while up for the third straight year, still fell almost 1.2 million units short of 1978's record 12.8 million vehicles. Moreover, American producers of production components continued to lose business at the margin to foreign rivals as Detroit's drive to improve the competitiveness of U.S.-made products resulted in more contract awards for overseas suppliers.

Increased outsourcing of original equipment parts by the U.S. Big Three from both affiliates and unrelated manufacturers in Japan was one reason imports of Japanese-made automotive parts expanded 22 percent last year to $4.2 billion. But greater purchases of engines, transmissions, starter motors, alternators, clutches and other products on the long list of production parts Detroit buys from Japan again took a backseat in the import expansion to bigger deliveries of replacement parts for Japanese cars and trucks.

The roughly 19.2 million Japanese vehicles sold in this country since 1977 have created an enormous market for replacement parts. Although hard numbers are missing, it is commonly thought that these sales are split about evenly between franchised new car and truck dealerships and other automotive sales and service outlets like repair shops and mass merchandisers. Japanese suppliers have a near monopoly on the parts requirements of dealers' service organizations, particularly major mechanical components. They have also made deep inroads in the other half of the aftermarket, which is the biggest sales channel for batteries, tires, spark plugs, filters, mufflers, brake parts and other high turnover parts.

On top of the import pull of the huge aftermarket for Japanese cars and trucks, the domestic assembly operations of Japanese automotive manufacturers are starting to inflate parts purchases. Five years ago none of Japan's nine major motor vehicle companies had a U.S. production facility. In 1985, however, Honda built 145,337 Accords at its Ohio plant, Nissan turned out 107,442 small pickups and 43,810 Sentra subcompacts in Tennessee, and NUMMI assembled 64,601 Toyota-designed subcompacts for sale under the Chevrolet name in its first full year of operation. With all three companies sourcing their engines, transmissions and differentials or transaxles as well as other key production components from Japan, the import numbers had to go up.

Capital Goods - After hiking capital spending by an awesome 29 percent over the 1983-84 period, U.S. business took a breather last year. Nowhere was this pause more evident than in the computer market as sputtering growth replaced the breakneck expansion of the early 1980s. The market's high fliers, personal computers, came back to earth, posting gains that outsiders would tag as robust but suppliers considered moderate, while minicomputer sales were lackluster and mainframe shipments disappointing. Few computer companies, American or foreign, were immune to the market's scaled-back performance, but judging by the import statistics, the ripple effect on Japanese vendors was surprisingly big.

Purchases of Japanese-made computers, peripherals and parts were up just 1.5 percent to $3.2 billion -- a far cry from 1984's 78.9 percent spurt and the 115 percent surge of the previous year. Although no product breakdown is available, indirect evidence suggests that Japanese manufacturers had a rough time across-the-board. At best, the group of companies that dominates U.S. sales of dot matrix and daisywheel printers for use with personal computers maintained shipments at 1984's level in the flat American printer market, but financial results were unquestionably hurt by another round of price-cutting. The story was much the same for Japanese floppy disk drive vendors, which now control the big domestic market for 5.25-inch drives and the smaller one for microfloppies: revenues fell in 1985's no-growth environment as a price war compounded a shipment drop. Business held up better for 5.25-inch rigid drives, but this did not translate into much of an import gain since Japanese competitors are the U.S. market's secondary players.

As weak as business might have been for Japanese makers of peripherals last year, they at least were able to keep shipments in the neighborhood of 1984 numbers. The same cannot be said for the handful of companies producing business-oriented personal computers for sale here. Having failed to dent the market the first time around with systems that were incompatible with International Business Machines Corp.'s PC, Japanese computer manufacturers discovered last year that climbing on the IBM PC bandwagon does not guarantee success either -- particularly in a rough-and-tumble market like 1985's.

The scaled-back pace of U.S. capital spending last year also trimmed growth in the telephone terminal equipment market, but this damper does not explain why imports of Japanese-made private branch exchanges, key systems and single-line telephones leveled off at $0.7 million. Part of the answer dates back to 1984, when purchases more than doubled and contributed to a glut that had still not been eliminated by the end of 1985. A resurgent American Telephone & Telegraph Co. also made life difficult for Japanese manufacturers of PBXs and key systems by halting the erosion of its huge customer base with popular product offerings and system enhancements. Paradoxically, the only market segment where Japanese suppliers made headway last year was the one in which they were thought to be at a competitive disadvantage -- telephones. But here Japanese makers simply filled the expanding niche for expensive feature-laden phones.

When sales of personal computers started to slow in 1984's second half and purchases of mainframes and minicomputers followed suit, the boom-and-bust U.S. semiconductor industry knew it was in trouble since computer makers had been generating anywhere up to half of its booming business. How much trouble soon became apparent as orders from merchant manufacturers' other major customers -- industrial and consumer electronics products, telecommunications equipment and military hardware -- weakened. But anemic demand turned out to be only the beginning of the industry's 1985 woes. With American makers and Japanese rivals scrambling for business to keep a huge amount of new capacity in operation, prices -- particularly for 64K dynamic random access memories, 256K chips and other high-volume memory products -- went into a tailspin.

The price war took a heavy toll on bottom lines in the U.S. merchant semiconductor industry. It also thinned the already reduced ranks of domestic companies making the workhorse 64K RAM. For other producers the latest bout of cutthroat RAM pricing was the final straw: they abandoned this end of the business altogether. But Japan's big semiconductor manufacturers were pinched as well. Admittedly, their problems were not as severe, yet a 34.6 percent cutback in U.S. purchases of Japanese-made semiconductors to $1.2 billion, on top of weak demand at home, did make for bumpy going. Moreover, after adding several points to their U.S. market share in 1984, Japanese suppliers apparently hit a roadblock last year.

While semiconductor producers were bearing the brunt of the slower pace of capital spending, U.S. machine tool builders continued to benefit from the orders placed in 1984 and 1985's first half by automotive manufacturers, defense contractors and other durable goods makers investing in plant modernization or expansion. These bookings lifted shipments by nearly one-fourth in 1984 and another one-tenth last year, but industry revenues still fell far short of their 1980-82 levels. The wait-and-see investment attitude of corporate planners in a number of important end-user industries was one cause of this gap. Equally important, American capital goods manufacturers bought more Japanese-made metal cutting and metal forming equipment, boosting imports 25.7 percent to just under $1 billion and raising Japan's share of U.S. apparent consumption to 21.6 percent, a 0.9 point gain. For products like small and medium-sized numerically controlled lathes and machining centers, purchasing managers had little choice since leading domestic machine tool builders have conceded commodity market segments like these to their Japanese competitors as part of a massive restructuring drive.

Consumer Goods - The surprising strength of consumer spending in 1985, the third year of the current U.S. economic expansion, translated into another record-breaking sales year for consumer electronics products. Color televisions remained the best sellers, both in volume and sales dollars, but video cassette recorders ran a close second on both counts. Falling prices continued to whet VCR demand, particularly in the market's low end, where discount prices on established brands broke through the $250 barrier. At the same time, the introduction of camcorders (portable one-piece camera-recorder combinations) boosted sales at the high end. Technology enhancements that make VCRs easier to use, more versatile and smaller also promoted the popularity of the machines. So did the continuing spread of neighborhood video stores with their constantly expanding libraries of prerecorded programming.

For Japanese consumer electronics manufacturers, which still supply almost all the VCRs sold here despite the arrival of Korean competitors, there was only one problem with 1985's upbeat picture: thin profit margins. As fast as retailers were moving VCRs out of stores (sales to dealers shot up from 7.6 million units in 1984 to almost 11.8 million last year), imports were expanding even faster, jumping from 9.3 million units to nearly 15.8 million worth $4.1 billion. This surge set the stage for another price war and, market watchers predict, an industry shakeout.

Intermediate Goods - With a cross-section of U.S. industry muddling along last year, few Japanese suppliers of intermediate goods posted good sales results. For Japanese steel makers, though, another factor was at work: limits on their U.S.-bound shipments. These restraints, negotiated in mid-March but retroactive to October 1, 1984, cut import volume 9.7 percent to 5,990,077 tons worth $3 billion-plus. They also trimmed Japan's share of apparent consumption to 6.2 percent from 1984's 6.7 percent level.

Higher output in the U.S. automotive industry -- steel's single largest customer -- and increasing production of appliances propped up shipments of domestically produced cold-rolled, hot-rolled and coated sheets but had no spillover effect on Japanese-made products. Similarly, mills in Japan were unable to capitalize on the strong demand for flat-rolled products as well as structural shapes and wire rods created by booming construction activity. They also did not benefit from the strength in the market for oil-country tubular products, although shipments of Japanese-made large diameter line pipe did expand. In fact, line pipe and standard and mechanical tubing were the only major steel products that increased in volume last year.

Import Prospects

No matter how the U.S. economy performs this year, the tally for imports from Japan will go up simply because of the yen's huge appreciation, but faster economic expansion -- an increasing possibility -- could add several more points to the growth rate. Another big increase is certainly in store for automotive products, if only because rising sticker prices seem to be having no impact on American demand for Japanese-made cars. Whatever happens in the VCR market, consumer goods could also chalk up another big gain since consumer spending still shows few signs of waning. At the same time, though, capital goods imports should increase by a relatively small margin since business investment is expected to continue rising at a modest rate. Moreover, intermediate goods could actually turn in a no-growth performance as lower steel shipments offset higher prices.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

U.S. Imports from Japan by Commodity, 1984 and 1985

(in millions of dollars* and indicated quantity units)

Commodity	Quantity 1984	Quantity 1985	Value 1984	Value 1985	Percent Change 1984/85	Japan's Share of U.S. Imports 1985
Total Imports			$57,135.0	$68,782.9	20.4%	19.9%
Automotive Products			18,902.9	24,980.0	32.1	37.4
Cars	1,950,406 no	2,527,467 no	12,349.9	16,231.3	31.4	44.5
Assembled Trucks	566,283 no	803,965 no	2,349.3	3,408.6	45.1	47.4
Truck Bodies (incl. cabs)	2,457 no	6,228 no	12.5	49.7	297.6	65.5
Truck Tractor Bodies	1,734 no	4,274 no	23.0	50.8	120.9	88.4
Automotive Parts, Accessories and Engines			3,631.6	4,429.5	22.0	22.0
Body Stampings			119.5	155.5	30.1	48.1
Bumpers			32.3	40.9	26.6	16.6
Wheels			32.3	71.1	120.1	20.3
Mufflers and Tailpipes			22.8	30.2	32.5	20.1
Brakes and Parts			55.9	66.8	19.5	10.9
Transmissions			155.2	252.2	62.5	20.2
Shock Absorbers			22.0	25.5	15.9	27.7
Engines and Parts			617.7	652.4	5.6	16.2
Engines	479,852 no	576,472 no	461.5	463.7	0.5	3.4
Parts			156.2	188.8	20.9	20.1
Starting and Ignition Equipment			134.2	165.9	23.6	42.8
Starting Motors	1,343,945 no	1,699,816 no	37.3	47.8	28.2	57.6
Ignition Wiring Sets			25.9	38.9	50.2	5.7
Pumps			50.1	54.9	9.6	26.4
Electric Lighting Equipment			41.0	53.1	29.5	35.3
Lead-Acid Batteries and Parts			20.0	29.6	48.0	29.9
Tires			426.0	467.2	9.7	29.5
Car Tires	6,433,383 no	8,027,564 no	171.5	207.7	21.1	24.1
Truck and Bus Tires	2,091,858 no	2,539,960 no	254.5	259.5	2.0	36.1
Radios	883,457 no	779,976 no	45.6	42.1	-7.7	11.7
Metal Hinges, Fittings and Mountings			27.2	34.8	27.9	14.1
Furniture			42.5	61.9	45.6	9.8
Snowmobiles	26,619 no	23,083 no	39.0	34.2	-12.3	51.2
Golf Carts, Mopeds and Similar Vehicles	548,410 no	743,539 no	478.6	726.3	51.8	94.3
Capital Goods			19,289.6	21,515.7	11.5	33.1
Nonelectric Machinery			12,891.9	14,448.9	12.1	36.2
Business Machines			6,414.6	6,274.1	-2.2	46.0
Office Typewriters	632,040 no	393,594 no	166.3	101.7	-38.8	55.0
Calculators	21,357,889 no	20,431,856 no	276.3	278.3	0.7	71.5
Cash Registers (excl. point-of-sale units)	396,024 no	431,156 no	97.0	108.3	11.6	97.3
Photocopiers and Parts			907.9	1,137.7	25.3	83.3
Photocopiers	762,703 no	897,676 no	723.3	892.8	23.4	82.9
Parts			184.6	244.9	32.7	84.5
Data Processing Equipment and Parts			3,185.4	3,233.6	1.5	39.9
Data Processing Equipment			1,873.4	1,924.9	2.7	48.1
Parts			1,312.1	1,308.7	-0.3	31.9

Commodity	Quantity 1984	Quantity 1985	Value 1984	Value 1985	Percent Change 1984/85	Japan's Share of U.S. Imports 1985
Machine Tools and Parts			$776.2	$975.8	25.7%	46.1%
Electric Discharge Machines	841 no	1,010 no	38.3	50.8	32.6	62.7
Numerically Controlled Lathes	2,889 no	3,765 no	173.8	220.3	26.8	86.2
Machining Centers	2,813 no	3,860 no	238.1	306.7	28.8	90.0
Milling Machines	373 no	483 no	17.1	46.6	172.5	34.9
Punching and Shearing Machines	1,461 no	1,611 no	62.3	70.2	12.7	47.8
Parts			78.7	109.9	39.6	29.5
Casting Machines Used in Metallurgy and Parts			15.6	112.5	621.2	48.3
Farm Tractors	60,383 no	72,264 no	247.3	280.5	13.4	85.7
Under 40 Horsepower	50,722 no	58,807 no	183.0	214.7	17.3	82.1
40-79 Horsepower	9,347 no	13,306 no	61.3	63.6	3.8	26.7
Hydraulic Excavators and Other Excavating Machinery and Parts			368.1	508.1	38.0	39.3
Front-End Loaders	3,314 no	4,742 no	148.4	208.1	40.2	41.8
Forklifts and Other Self-Propelled Work Trucks and Parts	28,495 no	34,426 no	231.3	274.1	18.5	50.3
Conveyors, Jacks and Other Materials Handling Equipment and Parts			151.1	180.2	19.3	21.5
Conveyors (except belt type)			38.1	22.0	-42.3	33.3
Hydraulic Jacks	518,934 no	624,224 no	33.6	41.1	22.3	43.4
Textile Machinery and Parts			174.7	176.2	0.9	22.5
Commercial Sewing Machines	139,764 no	181,795 no	61.7	59.7	-3.2	63.9
Weaving Machines and Parts			29.0	32.9	13.4	17.3
Knitting Machines and Parts			22.6	27.1	19.9	25.7
Pulp and Paper Mill Machinery and Parts			26.8	22.2	-17.2	5.7
Printing Equipment and Parts			134.9	181.3	34.4	25.6
Sheet-Fed Offset Printing Presses	278 no	420 no	43.9	73.9	68.3	27.8
Roll-Fed Offset Printing Presses	54 no	57 no	36.5	51.7	41.6	44.6
Machinery and Parts for Making Plastics and Rubber			65.6	105.1	60.2	25.0
Injection Molding Machinery	752 no	909 no	40.6	50.9	25.4	34.6
Machinery and Parts for Wrapping or Packaging Candy and Tobacco Products			17.5	26.4	50.9	8.3
Automatic Weighing Machinery			28.0	29.5	5.4	73.7
Industrial Equipment for Treating Materials by Temperature Change and Parts			20.2	57.3	183.7	18.2
Airconditioning Machinery and Parts			101.5	168.9	66.4	70.9
Pumps (except for motor vehicles) and Parts			52.7	74.2	40.8	12.6
Compressors and Parts			260.8	344.9	32.2	52.3
Refrigeration and Airconditioning Compressors Under 1/4 Horsepower	1,769,511 no	1,329,633 no	66.6	52.1	-21.8	34.2
Refrigeration and Airconditioning Compressors Between 1/4 and 1 Horsepower	883,597 no	1,214,069 no	37.8	54.4	43.9	65.0
Refrigeration and Airconditioning Compressors Over 1 Horsepower	2,393,572 no	3,114,718 no	112.9	153.7	36.1	90.5
Fans and Blowers (except for motor vehicles) and Parts			51.7	64.7	25.1	11.4
Power Hand Tools			164.3	187.6	14.2	48.6
Electric Hand Tools			101.4	135.0	33.1	57.5
Electric Drills	810,103 no	1,233,251 no	29.9	40.5	35.5	58.4
Electric Saws	315,789 no	566,079 no	22.7	34.6	52.4	80.9
Tools for Hand or Machine Use			120.0	162.4	35.3	22.5
Bearings and Parts			288.9	299.4	3.6	46.7
Radial Ball Bearings			113.8	119.7	5.2	49.3
Tapered Roller Bearings and Parts			112.3	100.8	-10.2	73.0

Commodity	Quantity 1984	Quantity 1985	Value 1984	Value 1985	Percent Change 1984/85	Japan's Share of U.S. Imports 1985
Taps, Cocks, Valves and Similar Devices and Parts			$110.4	$186.9	69.3%	21.9%
Speed Changers and Other Transmission Equipment			45.5	55.7	22.4	18.7
Small Stationary Diesel Engines and Parts			118.5	110.7	-6.6	22.7
Small Stationary Gas Engines and Parts			111.5	161.1	44.5	57.8
Steam Turbines and Parts			27.4	40.8	48.9	31.8
Electromechanical Apparatus and Parts			114.1	151.9	33.1	28.8
X-Ray Apparatus and Parts			57.7	85.7	48.5	16.5
Medical, Dental and Veterinary Instruments and Parts			127.3	154.5	21.4	35.1
Optical Instruments (excl. electro-optical)			76.4	88.4	15.7	74.0
Astronomical Instruments and Parts			89.5	113.1	26.4	72.6
Microscopes and Parts			51.5	64.4	25.0	44.9
Nonelectric Measuring, Checking, Analyzing and Controlling Instruments and Parts			100.7	163.5	62.4	30.5
Drafting and Marking Out Devices			37.0	47.2	27.6	35.5
Electric Measuring, Checking, Analyzing and Controlling Instruments and Parts			328.0	403.4	23.0	26.0
Instruments for Measuring or Controlling Liquids and Gases			29.3	56.8	93.9	27.2
Instruments for Physical or Chemical Analysis			29.9	31.3	4.7	24.0
Instruments and Apparatus for Checking or Measuring Electrical Quantities			104.8	119.4	13.9	41.1
Film Processing and Printing Equipment			77.9	106.4	36.6	57.0
Magnetic Media			542.9	761.6	40.3	71.0
Blank Audio Cassettes	66,671,006 no	70,235,346 no	76.8	80.7	5.1	52.6
Blank Video Cassettes	61,886,607 no	123,539,802 no	267.7	397.5	48.5	79.0
Blank Video Recording Media (excl. cassettes and cartridges)			91.3	131.8	44.4	83.3
Blank Computer Tape			29.9	54.2	81.3	57.6
Buildings, Door Frames and Other Structures of Nonferrous Metals			1.2	48.4	3,933.3	18.9
Electric Machinery			6,029.4	6,542.6	8.5	34.5
Semiconductors			1,843.6	1,205.7	-34.6	22.1
Discrete Devices			318.8	326.3	2.4	30.3
Transistor Parts			206.0	217.9	5.8	40.2
Integrated Circuits			1,524.8	879.4	-42.3	20.1
Linear (Analog) Chips	78,933,034 no	48,289,949 no	51.5	45.3	-12.0	7.9
Digital Bipolar Chips			130.0	93.2	-28.3	9.6
Digital Metal Oxide on Silicon Chips	311,431,437 no	201,655,545 no	1,282.1	699.8	-45.4	26.9
Chips, Dice and Wafers			149.8	119.8	-20.0	45.2
Printed Circuit Boards	10,075,647 no	9,359,894 no	78.9	81.0	2.7	27.7
Capacitors			152.1	121.2	-20.3	35.6
Fixed Aluminum Electrolytic Capacitors	900,924,266 no	817,518,745 no	67.8	55.8	-17.7	78.1
Fixed Ceramic Capacitors	1,590,846,445 no	1,426,328,366 no	42.8	36.7	-14.3	29.3
Electronic Tubes and Parts (excl. television picture tubes)			67.0	61.9	-7.6	28.7
Microphones, Loudspeakers and Amplifers and Parts			453.1	589.2	30.0	61.1
Loudspeakers	28,874,575 no	45,921,410 no	180.3	256.9	42.5	69.0
Audiofrequency Amplifiers	2,161,254 no	3,193,381 no	140.2	212.2	51.4	75.3
Television Cameras and Parts	846,612 no	791,827 no	483.7	426.0	-11.9	95.8
Radio Transceivers (excl. citizens' band)	606,711 no	618,314 no	125.5	129.6	3.3	51.0
Radar and Radio Navigational Aids and Parts			50.1	67.5	34.7	32.1
Radiotelephonic Apparatus and Parts			265.6	279.9	5.4	33.9

Commodity	Quantity 1984	Quantity 1985	Value 1984	Value 1985	Percent Change 1984/85	Japan's Share of U.S. Imports 1985
Telephone Apparatus and Parts			$730.4	$735.2	0.7%	46.7%
Telephone Switching Equipment and Parts			319.7	205.2	-35.8	39.2
Telephone Instruments	3,125,916 no	2,507,509 no	184.8	404.3	118.8	48.6
Teleprinting and Teletypewriting Machines and Parts			115.8	52.5	-54.7	68.5
Telegraph Appartus and Instruments and Parts			100.7	298.6	196.5	74.9
Switchgear			426.4	468.5	9.9	26.9
Switches			199.1	202.1	1.5	34.9
Relays			87.8	83.0	-5.5	43.1
Connectors			38.6	37.7	-2.3	15.0
Rectifiers and Rectifying Equipment			79.3	114.7	44.6	21.1
Resistors			101.8	82.9	-18.6	34.3
Insulated Electrical Conductors With Fittings			50.8	61.2	20.5	18.3
Electric Motors and Generators			188.9	179.6	-4.9	23.9
Electric Motors Under 1/40 Horsepower	13,672,910 no	12,859,644 no	92.6	83.6	-9.7	56.2
Generator Sets			42.0	52.2	24.3	24.3
Gasoline Engine Generators Not Over 5 Kilowatts	125,613 no	148,475 no	38.2	43.1	12.8	99.5
Welding Equipment and Parts			69.3	102.8	48.3	42.4
Batteries and Parts (excl. lead-acid batteries)			103.0	130.0	26.2	49.0
Nickel-Cadmium Storage Batteries	14,882,799 no	17,658,970 no	36.2	52.2	44.2	48.2
Permanent Magnets and Magnetic Workholders			59.9	79.3	32.4	46.1
Electric Signalling Apparatus and Parts			137.8	163.2	18.4	30.6
Transport Equipment			368.3	524.2	42.3	8.4
Civilian Aircraft			33.2	18.2	-45.2	1.0
Aircraft Parts			120.6	375.7	211.5	9.1
Self-Propelled Rail Vehicles	232 no	94 no	150.3	49.5	-67.1	53.0
Parts for Rolling Stock			36.1	58.9	63.2	27.4
Consumer Goods			11,265.6	14,017.2	24.4	20.5
Color Video Cassette Recorders	9,306,563 no	15,754,990 no	2,838.1	4,084.8	43.9	97.0
Black-and-White Video Cassette Recorders	5,087 no	141,778 no	2.8	48.8	1,642.9	98.9
Video Tape Players	144,631 no	195,485 no	69.5	81.1	16.7	95.3
Assembled Color Television Receivers	1,405,422 no	1,808,721 no	350.0	477.9	36.5	43.5
Assembled Black-and-White Television Receivers	672,945 no	714,861 no	62.6	64.7	3.4	25.2
Television Combinations			29.3	136.8	366.9	39.9
Unassembled Television Receivers and Incomplete Subassemblies			271.6	285.0	4.9	31.2
Television Picture Tubes and Parts			89.5	113.4	26.7	54.2
Parts for Television Receivers			656.1	649.6	-1.0	45.2
Converters, Preamplifiers, Amplifiers and Couplings for Cable Television			247.4	307.8	24.4	51.3
AM and AM/FM Radio Receivers (except for motor vehicles)	4,427,759 no	5,502,110 no	239.9	264.8	10.4	41.7
Radio Receivers (except entertainment broadcast band)			35.2	52.4	48.9	64.0
Radio-Tape Recorder Combinations	5,072,540 no	5,731,264 no	286.4	278.8	-2.7	41.4
Radio-Tape Player Combinations	10,132,064 no	11,220,463 no	574.3	675.7	17.7	50.2
Radio-Phonograph-Tape Recorder Combinations	614,032 no	646,504 no	69.7	225.8	224.0	86.9
Radio-Phonograph-Tape Player Combinations	125,357 no	527,422 no	8.9	35.4	297.8	38.3
Audio Tape Players	5,541,892 no	5,084,910 no	124.2	121.4	-2.3	61.5
Audio Tape Receivers and Dictation Machines and Parts			570.1	631.7	10.8	66.6
Tape Recorder and Tape Player Combinations (not incorporating radio or television receiver)			56.3	142.7	153.5	41.5
Record Players, Phonographs, Record Changers and Turntables and Parts	2,836,044 no	4,624,959 no	213.9	373.8	74.8	88.0

Commodity	Quantity 1984	Quantity 1985	Value 1984	Value 1985	Percent Change 1984/85	Japan's Share of U.S. Imports 1985
Electric Appliances and Parts			$641.7	$808.5	26.0%	35.9%
Refrigerators and Parts			53.5	70.7	32.1	26.2
Parts			16.7	42.3	153.3	50.4
Microwave Ovens	1,731,868 no	3,601,307 no	264.9	407.4	53.8	54.8
Electric Stoves and Ranges and Parts			195.1	172.2	-11.7	89.1
Window and Wall Airconditioners	90,311 no	116,194 no	18.5	26.5	43.2	49.0
Home Sewing Machines	253,961 no	228,556 no	31.1	31.5	1.3	20.1
Kerosene Heaters	837,560 no	1,218,757 no	39.6	56.6	42.9	56.0
Lawn Mowers and Parts			33.6	36.3	8.0	40.8
Portable Typewriters	1,138,201 no	1,421,237 no	99.3	120.6	21.5	68.2
Electric Filament Lamps (excl. sealed beams)			33.3	45.6	36.9	20.8
Earthen and China Tableware and Household Articles			367.9	392.0	6.6	39.8
Nonbone China Tableware	173,427,516 pc	195,497,796 pc	149.3	149.4	0.1	41.8
Earthen Tableware	268,660,860 pc	332,884,500 pc	156.7	177.2	13.1	56.8
Table Flatware and Kitchen Knives			115.5	106.6	-7.7	41.2
Metal Housewares			52.5	43.3	-17.5	8.7
Pipe Wrenches and Spanners and Parts			26.3	25.3	-3.8	19.7
Variable Focus Still Cameras	5,219,265 no	5,218,913 no	528.4	489.6	-7.3	86.9
Mounted Photographic Lenses	7,947,964 no	5,613,419 no	174.6	158.2	-9.4	78.6
Flash Apparatus			52.3	48.6	-7.1	63.7
Still Photographic Color Film (35 mm)	33,559,006 no	42,361,181 no	43.9	52.2	18.9	63.0
Optical Elements			92.6	107.0	15.6	30.9
Glasses and Frames			58.7	63.6	8.3	13.0
Frames	498,445 no	604,894 no	34.6	40.7	17.6	17.9
Clocks and Watches and Parts			435.6	476.2	9.3	34.9
Solid State Electronic Watches	6,570,353 no	8,565,226 no	53.3	52.0	-2.4	34.5
Other Watches Without Balance Wheel and Hairspring	9,660,652 no	14,815,614 no	249.6	305.6	22.4	44.2
Electric Clocks (incl. battery operated)	3,470,598 no	4,801,537 no	31.2	39.4	26.3	45.5
Toys and Sporting Goods			412.2	563.8	36.8	14.9
Toys			112.1	257.1	129.3	14.9
Rubber or Plastic Toys			17.5	126.2	621.1	30.9
Video Games and Parts			95.0	77.5	-18.4	56.3
Firearms and Parts			46.2	45.4	-1.7	25.6
Fishing Equipment			67.6	81.0	19.8	36.4
Musical Instruments and Parts			196.6	293.7	49.4	56.2
Pianos and Parts			49.2	57.3	16.5	51.8
Electronic Musical Instruments			91.5	175.7	92.0	84.4
Motorcycles and Parts (excl. engines)			661.5	883.8	33.6	92.6
Motorcycles	411,997 no	710,674 no	447.2	693.7	55.1	93.4
Motorcycles with Piston Displacement Over 290 cc	187,826 no	239,129 no	322.4	418.3	29.7	93.1
Parts (excl. engines)			214.3	190.1	-11.3	90.0
Adult Bicycles and Parts			140.2	124.1	-11.5	35.1
Bicycles	539,494 no	532,719 no	67.0	58.9	-12.1	26.2
Parts			73.2	65.3	-10.8	50.7
Outboard Motors	100,692 no	157,450 no	71.4	129.1	80.8	77.8
Clothing and Accessories			494.0	487.3	-1.4	3.3
Women's and Girls' Cotton Jackets	2,638,776 no	1,793,892 no	35.2	23.4	-33.5	11.1
Women's Cotton Slacks	10,103,280 no	11,099,292 no	69.5	78.8	13.4	13.1
Women's and Girls' Cotton and Manmade-Fiber Knit Shirts	10,044,264 no	7,794,456 no	30.5	23.0	-24.6	4.2
Men's and Boys' Cotton Knit Shirts	7,372,776 no	4,117,704 no	35.8	23.8	-33.5	6.7
Footwear			26.4	19.3	-26.9	0.3
Furniture			44.6	68.6	53.8	2.6

Commodity	Quantity 1984	Quantity 1985	Value 1984	Value 1985	Percent Change 1984/85	Japan's Share of U.S. Imports 1985
Pearls (not set or strung)			$215.2	$200.4	-6.9%	86.7%
Jewelry			60.0	67.2	12.0	3.0
Works of Art			45.4	40.0	-11.9	4.1
Printed Material			133.5	153.1	14.7	13.7
Pens and Pencils			96.8	109.4	13.0	62.3
Ballpoint Pens	124,720,274 no	186,712,492 no	28.9	38.9	34.6	64.0
Cigarette Lighters and Parts			24.2	29.3	21.1	33.6
Pharmaceuticals			138.4	165.5	19.6	9.3
Bulk Vitamins			43.1	42.2	-2.1	30.0
Benzenoid Drugs			59.0	75.8	28.5	10.7
Intermediate Goods			6,849.6	7,035.3	2.7	6.2
Steel Mill Products	6,630,005 stn	5,990,077 stn	3,149.9	3,048.3	-3.2	31.4
Wire Rods and Bars	1,319,378 stn	1,190,072 stn	495.1	453.1	-8.5	25.5
Unalloyed Wire Rods	282,183 stn	236,553 stn	107.3	84.7	-21.1	22.0
Cold-Formed Unalloyed Bars	77,509 stn	72,849 stn	35.7	34.0	-4.8	31.9
Semifinished Angles, Shapes and Sections Over 3"	711,502 stn	669,259 stn	215.7	202.3	-6.2	33.8
Plates and Sheets	3,315,994 stn	2,945,492 stn	1,597.8	1,430.3	-10.5	33.8
Tin Plate and Tin-Coated Sheets	211,071 stn	253,122 stn	120.7	137.2	13.7	63.5
Coated Plates and Sheets	1,683,098 stn	1,492,082 stn	817.9	748.0	-8.5	55.5
Unalloyed Non-Pickled Plates and Pickled Sheets	285,145 stn	214,634 stn	95.2	72.0	-24.4	9.1
Black Plate	166,149 stn	141,149 stn	67.8	59.8	-11.8	59.7
Unalloyed Hot-Rolled Sheets	190,816 stn	130,642 stn	62.5	43.1	-31.0	10.4
Unalloyed Cold-Rolled Sheets	830,497 stn	624,185 stn	329.5	257.7	-21.8	27.4
Plates, Sheets and Strip of Alloy Tool Steel	48,414 stn	58,461 stn	49.5	58.4	18.0	44.1
Strip	65,720 stn	72,072 stn	71.0	82.0	15.5	30.3
Alloy Tool Steel Strip	20,021 stn	31,581 stn	33.5	48.5	44.8	59.0
Rails	193,868 stn	210,896 stn	69.2	83.5	20.7	65.3
Wire (excl. flat wire and insulated electric wire)	184,694 stn	140,617 stn	121.4	100.8	-17.0	25.3
Unalloyed and Uncoated Wire	137,235 stn	94,322 stn	76.4	54.5	-28.7	32.8
Tubes, Pipes and Fittings	1,405,798 stn	1,425,788 stn	788.4	889,6	12.8	36.4
Cast Fittings, Forged Steel Flanges and Butt-Weld Fittings	37,238 stn	40,414 stn	52.4	67.0	27.9	39.8
Unalloyed Welded or Seamless API Line Pipe	238,058 stn	271,457 stn	91.2	114.5	25.5	30.9
Unalloyed Welded or Seamless Pipes and Tubes, Not Threaded	269,188 stn	189,680 stn	101.7	68.6	-32.5	24.1
Unalloyed Welded or Seamless Pipes and Tubes, Threaded	258,045 stn	261,114 stn	157.3	179.9	14.4	68.2
Unalloyed Pipes and Tubes of Circular Cross Section	173,439 stn	186,789 stn	90.4	103.8	14.8	49.8
Stainless and Alloy Tool Steel Pipes and Tubes	58,741 stn	90,855 stn	77.0	118.3	53.6	46.4
Nonferrous Metals			506.4	535.0	5.6	7.6
Copper and Copper Alloys			114.0	106.9	-6.2	9.3
Pipes and Tubes			58.3	62.2	6.7	41.6
Aluminum and Aluminum Alloys			331.1	347.5	5.0	17.4
Wrought Aluminum Sheets and Strip, Not Clad	142,521 stn	152,993 stn	302.9	313.8	3.6	51.4
Titanium	5,256 stn	3,476 stn	34.6	28.5	-17.6	66.8
Steel Pillars, Girders and Similar Structural Units			36.9	30.0	-18.7	19.8
Metal Containers			29.6	141.0	376.4	47.7
Wire Products (excl. insulated electric wire)			122.6	140.1	14.3	28.1
Steel Wire Strand, Unfitted and Uncovered	44,404 stn	48,610 stn	45.8	47.4	3.5	35.1
Brass-Plated Steel Rope and Cable, Unfitted and Uncovered	20,352 stn	24,800 stn	41.6	49.8	19.7	36.3

Commodity	Quantity 1984	Quantity 1985	Value 1984	Value 1985	Percent Change 1984/85	Japan's Share of U.S. Imports 1985
Nails and Industrial Fasteners			$438.2	$419.4	-4.3%	39.5%
Steel Bolts and Bolts With Nuts	62,571 stn	55,320 stn	55.4	51.1	-7.8	39.7
Steel Nuts	61,801 stn	56,105 stn	90.9	88.8	-2.3	53.1
Steel Screws	181,519 stn	177,510 stn	209.1	200.5	-4.1	61.1
Steel Chains			61.9	60.6	-2.1	45.2
Industrial Chemicals (excl. fertilizers and pharmaceuticals)			1,047.2	1,098.1	4.9	16.2
Organic Chemicals Found Naturally in Coal Tar			26.0	69.9	168.8	11.7
Benzene	17,139,613 gal	26,770,814 gal	22.3	34.6	55.2	18.5
Toluene	0 gal	24,603,243 gal	0.0	29.7	100.0	17.7
Other Cyclic Organic Chemical Products			151.3	123.1	-18.6	16.7
Aromatic or Odoriferous Compounds (incl. flavors)			40.3	57.8	43.4	35.9
Organic Acids, Acid Anhydrides and Salts			34.9	42.9	22.9	15.7
Amino Acids and Other Nitrogenous Compounds			127.1	113.5	-10.7	17.5
Synthetic Organic Dyestuffs			103.1	117.2	13.7	35.4
Plastic Materials and Resins			310.1	321.4	3.6	22.9
Polystyrene Resins and Styrene Copolymers and Terpolymers			52.2	24.3	-53.4	30.6
Flexible Film, Strips and Sheets of Plastic Materials			125.0	135.1	8.1	26.0
Synthetic Rubber			28.3	35.5	25.4	11.5
Rubber or Plastic Hose, Pipe and Tubing			26.5	35.7	34.7	20.3
Rubber or Plastic Gaskets			28.3	34.1	20.5	21.1
Tires and Tubes (excl. car, truck and bus tires)			90.3	94.8	5.0	27.8
Plywood and Veneers	119,315 msf	114,099 msf	42.8	37.4	-12.6	4.8
Paper Products			79.2	106.4	34.3	1.9
Coated Paper and Paperboard			40.8	66.7	63.5	6.4
Yarns, Fabrics and Made-Up Textile Articles			671.0	715.2	6.6	14.6
Manmade-Fiber Yarn	13,814 stn	9,630 stn	56.1	42.5	-24.2	12.5
Cotton Fabrics	79,031,384 syd	111,755,237 syd	111.0	142.6	28.5	17.0
Manmade-Fiber Fabrics	229,130,365 syd	217,790,778 syd	260.4	272.2	4.5	35.3
Fabrics 85 Percent or More By Weight Polyester	n.a.	134,181,919 syd	n.a.	135.9	n.a.	55.3
Wool Fabrics	6,804,987 syd	7,338,185 syd	30.4	27.6	-9.2	19.5
Wadding, Batting and Nonwoven Fabrics	1,463 stn	1,834 stn	44.7	41.9	-6.3	49.5
Ceramic Tile	67,595,951 sft	80,536,221 sft	56.4	66.5	17.9	24.9
Electrodes for Electric Furnaces and Electrolytic Use	37,724 stn	36,791 stn	64.1	64.9	1.2	66.8
Coke for Use as Fuel	354,308 stn	464,265 stn	29.7	36.0	21.2	84.0
Photographic Film and Paper (excl. film packaged for retail sale)			293.1	345.7	17.9	45.3
Medical X-Ray Film	110,129,217 sft	90,220,783 sft	67.8	71.7	5.8	54.8
Silver Halide Color Photographic Paper	443,728,422 sft	686,697,071 sft	103.8	133.9	29.0	52.6
Food and Feed			443.9	500.3	12.7	2.3
Fish and Fish Products			244.6	278.1	13.7	7.0
Fresh, Chilled or Frozen Tuna	58,937 stn	26,618 stn	70.0	42.7	-39.0	19.9
Scallops	3,600 stn	5,441 stn	31.9	43.7	37.0	29.7
Alcoholic Beverages			25.6	27.7	8.2	0.9
Miscellaneous Imports			383.4	734.4	91.5	7.8

Key to quantity abbreviations:
gal = gallons
msf = thousand square feet
no = number
pc = pieces
sft = square feet
stn = short tons
syd = square yards

*Imports are valued on a Customs value basis.

Source: U.S. Department of Commerce, U.S. General Imports: Schedule A Commodity by Country (FT 135), December 1984 and December 1985

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REPORT

NO. 19B
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Sour Taste Lingers From Summit

Perceptions that Prime Minister Yasuhiro Nakasone failed to effectively represent Japanese interests in the recent economic summit linger in Japan, complicating the incumbent's hope of remaining in office beyond October 1986 as president of the Liberal Democratic Party. Although criticism has not been universal, several major dailies have expressed disappointment with the results of the seven-nation meeting, particularly the explicit reference to Libya and the failure to secure a commitment to stabilize the yen's value.

In some respects, Mr. Nakasone may have been a victim of the consensus-building process that characterizes Japanese politics. Led by the United States, the declaration on terrorism was included on the summit agenda more rapidly than Japan would have liked. Tokyo press reports suggest that preliminary drafts of the anti-terrorism proclamation did not refer to any specific finance ministers of the seven nations to meet periodically to assess their economies, based on 10 indicators: economic growth rates, inflation rates, interest rates, unemployment rates, budget deficits, current account and trade balances, monetary growth rates, reserves and exchange rates. It will then be up to the finance ministers to decide on appropriate measures, including intervention in exchange markets, whenever there are significant deviations from the projected course.

While most economists praised the plan as a constructive step toward more stable exchange rates, it is not clear that the proposal can be effectively implemented. With no enforcement mechanism save peer pressure and the force of public opinion, it is an open question whether or not the agreement will produce more consistent economic policies. C. Fred Bergsten, director of the Institute for International Economics, called the plan an "impressive step forward," but said it would "need an independent referee to blow the whistle."

Economists also praised the plan for focusing on the economic fundamentals that determine exchange rates rather than on intervention. Although intervention was successful last fall because it was consistent with market trends, it is unlikely to reverse the direction of a market that trades $150 billion a day. For example, intervention by the Bank of Japan, estimated at about $300 million on May 8, was unable to slow the currency's rise.

Responding to alarm over the pace of the yen's appreciation, Prime Minister Yasuhiro Nakasone renewed his call May 9 for coordinated intervention to stablize its value. A report that the central banks of Japan and West Germany had agreed to a joint effort to slow the dollar's fall was denied, indicating that Japan stands alone in its effort to stop the dollar's plunge. Finance Minister Noboru Takeshita told the Diet that he wants an early meeting of the Group of Five finance ministers to discuss exchange rates.

The sharp appreciation of the yen to the Y160 level has made an exchange rate of Y150=$1.00 before summer a real possibility, according to some market analysts. The Nihon Keizai Shimbun econometric model predicts that the rise of the yen from the Y165 level to Y150 will lower inflation-adjusted growth in FY 1986 from 2.3 percent to 1.5 percent, while reducing the increase in the consumer price index from 1 percent to 0.4 percent.

Randall S. Jones

DOD Burdensharing Report: "Significant Steps"

The Department of Defense's annual "Report on Allied Contributions to the Common Security" concludes that Japan's present defense funding levels -- if continued -- will result in "significant steps" toward improved security in the Pacific. In a far more detailed report than it had produced in recent years, DOD said that Tokyo's steps to enhance its defense capabilities, including coverage of the sealanes approaching Japan, were generally in the right direction.

The report notes that the first year of Japan's current five-year defense plan has been sufficiently funded to achieve its stated goals. All major frontline procurement requests were met and spending on sustainable items

Total Active Duty Military Manpower

(in thousands)

Country	1971			1984			Percent Change 1971-84
	Number	Percent of NATO/Japan Total	Rank	Number	Percent of NATO/Japan Total	Rank	
United States	2,714.0	42.9%	1	2,222.0	35.1%	1	-18.1%
Turkey	614.5	9.7	2	814.5	12.9	2	32.5
France	569.3	9.0	3	570.5	9.0	3	0.2
Italy	526.0	8.3	4	507.7	8.0	4	-3.5
Spain	---	---	-	491.3	7.8	5	n.a.
West Germany	472.0	7.5	5	487.5	7.7	6	3.3
United Kingdom	384.0	6.1	6	336.3	5.3	7	-12.4
Japan	234.3	3.7	8	241.0	3.8	8	2.9
Greece	178.7	2.8	9	197.1	3.1	9	10.3
Belgium	106.8	1.7	11	107.1	1.7	10	0.3
Netherlands	113.0	1.8	10	103.3	1.6	11	-8.6
Portugal	244.2	3.9	7	100.3	1.6	12	-58.9
Canada	86.9	1.4	12	82.0	1.3	13	-5.6
Norway	36.3	0.6	14	39.5	0.6	14	8.8
Denmark	44.5	0.7	13	30.8	0.5	15	-30.7
Luxembourg	1.1	0.0	15	1.2	0.0	16	11.8
Non-US NATO	3,377.3	53.4		3,869.1	61.1		14.6
Non-US NATO + Japan	3,611.6	57.1		4,110.1	64.9		13.8
Total NATO	6,091.3	96.3		6,091.1	96.2		0.0
Total NATO + Japan	6,325.6	100.0		6,332.1	100.0		0.1

Source: Department of Defense, Report on Allied Contributions to the Common Defense: A Report to United States Congress, March 1986.

Total Defense Spending as Percent of GDP, 1971 and 1984

Country	1971 Percent	1971 Rank	1984 Percent	1984 Rank	Percent Change 1971-84
Greece	4.7%	4	7.2%	1	53.8%
United States	7.1	2	6.5	2	-7.6
United Kingdom	4.9	3	5.3	3	8.0
Turkey	4.5	5	4.4	4	-3.1
France	4.0	6	4.1	5	3.2
West Germany	3.4	9	3.3	6	-2.6
Portugal	7.4	1	3.3	7	-56.0
Netherlands	3.4	7	3.2	8	-6.2
Belgium	2.9	10	3.2	9	11.2
Spain	--	--	2.9	10	n.a
Norway	3.4	8	2.8	11	-16.3
Italy	2.7	11	2.7	12	-0.7
Denmark	2.4	12	2.3	13	-5.0
Canada	2.2	13	2.2	14	-3.1
Luxembourg	0.8	15	1.2	15	50.0
Japan	0.8	14	1.0	16	20.4
Non-US NATO	3.6		3.5		-0.5
Non-US NATO and Japan	3.0		2.8		-6.1
Total NATO	5.5		5.2		-5.0
Total NATO and Japan	5.0		4.6		-8.4

Naval Force Tonnage* and Tactical Air Combat Aircraft, 1984

Country	Naval Forces: Percent of NATO/Japan Total	Naval Forces: Rank	Aircraft: Percent of NATO/Japan Total	Aircraft: Rank
United States	63.69%	1	41.30%	1
United Kingdom	10.85	2	9.21	3
France	4.88	3	9.29	2
Spain	3.29	4	1.87	6
West Germany	3.17	5	8.73	4
Japan	3.13	6	4.12	7
Spain	2.19	7	1.87	12
Italy	1.77	8	5.86	5
Canada	1.79	9	2.39	10
Greece	1.77	10	4.01	8
Netherlands	1.42	11	2.29	11
Portugal	0.63	12	1.13	15
Norway	0.62	13	1.47	13
Denmark	0.43	14	1.38	14
Belgium	0.29	15	2.51	9
Luxembourg	0.00	16	0.00	16
Non-US NATO	33.18		55.58	
NON-US NATO + Japan	36.31		58.70	
Total NATO	96.87		95.88	
Total NATO + Japan	100.00		100.00	

*Not including strategic submarines.

was also raised for fiscal 1986 (April 1, 1986-March 31, 1987). The report implies that the one percent of GNP spending limit will be broken during the course of the five years since Japanese government officials have given the acquisition goals of the plan higher priority than the one-percent limit. Ammunition outlays were increased by 13.8 percent over FY 1985, an area that is of considerable concern to DOD officials because of existing deficiencies.

While the report reiterates previous years' remarks that Japan "ranks close to last or last on most performance measures compared to ability to contribute," the document goes on to note that "Japan recognizes this obligation and has the second highest percentage change in defense spending from 1971-1984." It adds that the Nakasone cabinet has continuously given high priority to defense in its budgets.

In accordance with the 1985 Byrd amendment, the 1986 burdensharing report specifically analyzes Japan's progress toward meeting the goal of defending the sealanes to a distance of 1,000 nautical miles. The DOD study concludes that measures now in implementation or under study, "if continued on the route to full funding, [represent] the necessary minimum to meet Japan's defense goals, including defense of the sealanes to 1,000 miles." While emphasizing that future adjustments may be necessary to meet changes in the security situation, "Japan's 1986-1990 program does represent an appropriate, significant step forward in achieving Japan's defense goals."

While these observations may not be what congressional critics of Japan's defense policies hoped for when they overwhelmingly approved the Bryd amendment, the report nevertheless keeps defense issues active and in that sense results in continued pressure on Japan to maintain at least the present pace in improving its defense capabilities. The overall tone of the report is balanced and defenders of Japanese policies can find more than enough evidence in it to justify their positions. In fact, the report is almost upbeat in its assessments of Japanese capabilities.

Michael W. Chinworth

Update On Japan's Telecommunications Market

One year after liberalization, Japan's telecommunications market is humming with activity. While many domestic and foreign companies are making good progress, others have stumbled. In addition, deregulation fever has spread to the international communications area, even though the original legislation did not explicitly include it. While many U.S. officials are willing to give Tokyo a chance to prove that American firms will be treated fairly in Japan's deregulated market, a House committee has nonetheless approved legislation implementing tough reciprocity guidelines for telecommunications equipment. As expected, Tokyo's response to the bill has been negative.

The Type I, or common carrier, market is proving to be fertile ground for foreign companies, even though they are barred by law from majority ownership of Type I companies. Daini Denden Inc., a consortium of firms building a microwave network in the Tokyo-Kyoto corridor, will use equipment produced by

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REPORT

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REFORM OF THE INTERNATIONAL MONETARY SYSTEM

Summary

The sharp increase in the value of the dollar from 1980 to 1985 has fueled rising discontent with the present exchange rate system. Many countries, including the United States, have expressed interest in reforming the international monetary system to provide greater stability to currency values. But there remains a wide divergence of views on both the wisdom and feasibility of altering the current system. Reform, therefore, is likely to be a gradual process.

There is increased support for fixed exchange rates or target zones for currencies. But since disruptive exchange rate changes are the manifestation rather than the source of most economic problems, the most important reform is better macroeconomic policies. The international harmonization of policies necessary to maintain stable exchange rates remains difficult, though, given the reluctance of governments to subordinate domestic policy to exchange rate considerations. The plan approved at the Tokyo summit for increased coordination and monitoring of policies is a promising first step.

Increasing Frustration With The Current System

The appreciation of the dollar, which rose nearly 56 percent between July 1980 and February 1985 on a trade-weighted basis relative to the currencies of the ten largest industrial countries, has had a powerful impact on [illegible]

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world economy. The strong dollar is the major cause of the $271 billion in U.S. current account deficits during the past three years and of its shift from the world's largest creditor country to the largest industrial debtor country. The European nations, which need investment capital to encourage growth and reduce double-digit unemployment rates, have been critical of high U.S. interest rates, which encouraged capital flows to this country.

The pressures on the world trading system resulting from the sharp currency changes of the past few years have increased support for international monetary reform. France has campaigned for an international monetary conference and the Group of 24, which represents developing countries, has urged the International Monetary Fund to study a system of "target zones," under which countries coordinate policies and market intervention activities to keep exchange rates within agreed ranges. The first-term Reagan administration view, which opposed intervention in exchange markets and accepted the strong dollar as a reflection of confidence in the U.S. economy, has also shifted considerably. In his 1986 State of the Union address, President Reagan said "We must never again permit wild currency swings to cripple our farmers and other exporters," and instructed Treasury Secretary James Baker to study the possibility of an international monetary conference.

The benign neglect of exchange rate policy ended September 22, 1985, when the Group of Five -- the United States, Japan, West Germany, France and Great Britain -- agreed to take measures to lower the value of the dollar. Since then the dollar has fallen 16.3 percent against the ten-nation basket of currencies (see Table 1) and the G-5 has orchestrated two coordinated interest rate cuts. At the recent economic summit in Tokyo, participants agreed to try to formalize and expand the G-5 system to promote economic growth and exchange rate stability. The agreement, termed "managed floating," requires the finance ministers of the seven summit countries to meet periodically to coordinate policy and monitor economic data, taking into account the following indicators: economic growth rates, inflation rates, interest rates, unemployment rates, budget deficits, current account and trade balances, monetary growth rates, reserves and exchange rates. The group is instructed to develop remedial measures whenever there is significant deviation from the projected course. There is no indication, however, that the agreement is intended to control the day-to-day variations in exchange rates or to set target zones for currencies. The plan is similar to that suggested by the IMF's interim committee in April for multilateral surveillance by the IMF based on "objective indicators."

The Floating Exchange Rate System

Economic events in the 1960s and early 1970s weakened the system of fixed exchange rates established at the Bretton Woods Conference in 1944. The Smithsonian agreement in 1971, which devalued the dollar, failed to stem mounting pressure on the system. Major currencies began to float when a second currency alignment collapsed in March 1973, and attempts to reestablish fixed rates were abandoned in the turbulence following the first oil shock. Three years later, in January 1976, the finance ministers of the IMF nations officially approved the system of floating currencies while allowing countries to maintain the exchange arrangement of their choice.

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Table 1: Changes in the Dollar

Currency	Percent Change From September 20, 1985 to May 2, 1986	Percent Change From February 26, 1985 to May 2, 1986	Percent of Dollar's Appreciation Reversed*
Japanese yen	-30.0%	-35.2%	223.2%
Canadian dollar	-0.1	-1.8	8.4
Swiss franc	-22.0	-37.0	81.1
German mark	-23.6	-36.5	73.0
British pound	-11.1	-31.5	35.8
French franc	-20.1	-33.8	54.5
Italian lira	-22.0	-30.2	48.8
Special Drawing Rights	-12.7	-19.1	57.8
European Currency Unit	-20.4	-34.2	41.0
Trade-Weighted Average of G-10 Currencies	-16.3	-24.7	50.6

*This column indicates the portion of dollar appreciation between July 22, 1980 and February 26, 1985 that has been reversed by the subsequent depreciation of the dollar.

Source: Department of the Treasury (based on London mid-day rates)

While most major currencies have been allowed to float, a number of developing nations and small industrial countries have remained with fixed exchange rates. In 1985, 68 percent of the IMF's 149 member-countries maintained a fixed exchange rate (see Table 2). Thirty-six countries peg their currency to the U.S. dollar, 14 to the French franc and 13 to the IMF's Special Drawing Rights. The remainder are linked to another currency or basket of currencies. The popularity of flexible exchange rates, as indicated by the number of countries that follow this system, has risen from 22.9 percent to 32 percent during the past eight years.

Floating exchange rates were expected to eliminate currency misalignments and automatically balance a country's external payments. Trade deficits, in this view, would be corrected by a declining currency that increased exports and reduced imports, making it unnecessary to impose restrictions on trade and capital flows for macroeconomic reasons and enhancing the efficiency of resource allocation in the world economy.

The most important argument in favor of flexible exchange rates is that, on paper at least, it would insulate a nation's economy against shocks from abroad and allow policymakers greater independence to pursue domestic stabilization goals. Excess supply or demand for a currency under a fixed exchange rate system forces monetary authorities to adjust the currency supply to keep the exchange rate at a specific level. As a result, governments lose control of monetary policy. Under floating rates, however, the price (exchange rate) is allowed to equilibrate demand and supply, permitting monetary authorities to pursue domestic objectives, such as interest rate levels and money supply growth.

Table 2: Types of Exchange Arrangements Maintained by IMF Members

(percent of total)

End of Year*	Fixed**	Managed Floating	Freely Floating
1977	77.1%	12.2%	10.7%
1978	74.5	15.3	10.2
1979	72.7	16.5	10.8
1980	72.1	17.2	10.7
1981	72.5	16.9	10.6
1982	71.7	17.3	11.0
1983	69.0	20.0	11.0
1984	68.7	17.7	13.6
1985	68.0	17.0	15.0

*Figures for 1977 and 1985 are for October and March, respectively.

**Includes pegged arrangements and arrangements in which flexibility is limited vis-a-vis a single currency. Freely floating includes cooperative arrangements and independently floating arrangements.

Source: IMF Survey, September 23, 1985.

But the appreciation of the dollar from 1980 to 1985 -- the largest real exchange rate movement in modern history -- and the unprecedented U.S. trade deficits indicate that the floating exchange rate system is not working as expected. While flexible rates have freed governments from worrying about the impact of domestic economic policies on the exchange rate, they have not freed economies from the impact of exchange rate changes. Nor have they insulated countries from overseas shocks as hoped.

Under the floating exchange rate system, there has been an increase in the volatility of exchange rates and a significant misalignment of currencies. According to the IMF, the average monthly fluctuation in the exchange rates of industrial countries was nearly ten times greater from 1971 to 1981 than from 1948 to 1971. The increase in the volatility of four major currencies under the floating exchange rate system is shown in Table 3. There has also been a marked increase in swings in real exchange rates under the floating system (see Table 4).

Table 3: Exchange Rate Volatility*

Currency	1968	1969	1975	1982
German mark	0.3%	1.2%	1.7%	1.6%
French franc	0.1	2.3	1.6	2.2
Japanese yen	n.a.	n.a.	0.7	2.5
British pound	0.7	0.2	1.0	1.1

*Coefficient of variation of daily nominal exchange rate against dollar around six-month moving average, expressed as percentage.

Source: John Williamson, The Exchange Rate System (Washington, D.C.: Institute for International Economics, 1983), p. 12.

Table 4: Maximum Swings in Real Exchange Rates

(in percent)

Currency	1963-72	1973-82
German mark	13%	22%
French franc	27	19
Japanese yen	14	35
British pound	17	60
U.S. dollar	14	32
Average	17	34

Source: John Williamson, The Exchange Rate System (Washington, D.C.: Institute for International Economics, 1983), p. 17.

Although in some sense it is incorrect to say that a currency whose value is determined by market forces is "overvalued," economists generally believe the dollar's strength in the first half of the 1980s was not justified by economic fundamentals, such as the U.S. current account and changes in productivity and prices. John Williamson of the Institute for International Economics calculated that in September 1985 the dollar was overvalued by 30 to 40 percent compared with the underlying competitive relationship between the United States and other major countries.

The volatility of exchange rates is explained by the fact that, like other financial assets, the price reflects all the information that may have a bearing on its value. The market continually appraises new information and adjusts its expectations of the future. The increased volatility of exchange rates during the past ten years reflects the tremendous surge in capital-flows resulting from the growing integration of world capital markets. Advocates of flexible rates, who expected currency values to be determined largely by trade flows, did not anticipate the doubling of the volume of foreign exchange trading from $75 billion a day in 1979 to $150 billion in 1984 (see Table 5). Former Citicorp chairman Walter Wriston estimates that international dollar capital flows now exceed world trade volume by a factor of fifty to one.

Table 5: Daily Foreign-Exchange Trading*

(percentage of total)

Market	1979	1984
London	33%	33%
New York	23	24
Frankfurt	15	11
Zurich	13	14
Paris	5	3
Singapore	4	5
Hong Kong	4	5
Tokyo	3	5

*Daily volume totaled $75 billion in 1979 and $150 billion in 1984.

Source: The Economist, November 30, 1985, p. 83.

It is widely believed that misaligned currencies are the result of inappropriate macroeconomic policies that push exchange rates away from levels consistent with current account balances, allowing for small net capital flows. Inefficiencies in the exchange market may also explain the divergence of exchange rates from equilibrium levels. An appreciating currency creates a bandwagon effect, as traders rush to buy it, hoping to make a profit by selling it at a higher value. Economists believe that exchange rates can be pushed away from equilibrium values as long as participants believe that the risk of reversal falls short of the prospect of further gain. This bandwagon effect, based on market dynamics, can outweigh economic fundamentals and create a speculative bubble that persists for long periods.

Although studies of the effects of exchange rate volatility on trade have reached no firm conclusion, a recent report by Keith Maskus of the Federal Reserve Bank of Kansas City estimates that volatility reduced total U.S. trade by 3.2 percent between 1974 and 1984. It had the greatest impact on agricultural trade, lowering it by 6 percent. Rapid exchange rate changes hinder trade by creating uncertainty about the profits or costs of international transactions. Volatility can also lead to higher prices by causing traders to add a risk premium to cover unanticipated exchange rate fluctuations.

The misalignment of currencies is a more serious problem that leads to a shifting of resources between industries producing tradable goods and those producing nontradables on the basis of misleading prices. While such dislocation costs may be worthwhile to achieve a permanent improvement in the allocation of resources, the cost-benefit ratio is not as favorable when based on a temporary misalignment of currencies. These costs include the retraining of labor and the construction of new capital equipment, both of which absorb real resources.

The manufacturing sector, in particular, benefits from an environment of stability, in which factors such as cost and profit margins can be calculated with a degree of certainty. An overvalued exchange rate leads industries to shift production overseas or scrap capacity that could be productively employed at equilibrium exchange rates. Similarly, an undervalued exchange rate can encourage investment in excess capacity that will later have to be abandoned or subsidized. Moreover, repeated wide swings in currency values give rise to uncertainties that discourage investment. Not surprisingly, the Business Roundtable, composed of the leaders of the 200 largest U.S. firms, has called for an international monetary conference to increase the stability of exchange rates.

An overvalued currency increases unemployment, as the retraining of workers released from declining industries typically begins only after months or years of unemployment. Not surprisingly, the hike in unemployment often encourages a surge of protectionist pressure. C. Fred Bergsten, director of the Institute for International Economics, points out that three major postwar episodes in U.S.-Japan trade friction originated in periods of an overvalued dollar. Some economists believe that repeated misalignments raise the rate of inflation. It has been observed that pressure for wage increases following a currency depreciation, which raises prices, is greater than the pressure for wage restraint following currency appreciation. A depreciation followed by a matching appreciation, therefore, will leave the price level higher than it would have been.

A Return To Fixed Exchange Rates?

These problems have prompted some politicians and economists to favor a return to fixed rates to provide a more stable environment for economic growth. There has even been some support, notably from Rep. Jack Kemp (R, N.Y.), for a new gold standard. The two major elements of the gold standard were: (1) maintenance of the equal value of the currency and gold through the unrestricted purchase and sale of gold at a fixed price; and (2) limiting the money supply through gold reserve requirements. Exchange rates were kept within a narrow range through gold flows between countries. Since the money supply was determined by the gold reserve, an inflow or outflow of gold caused an automatic expansion of money and credit.

Those favoring a return to the gold standard contend that it is a long-term anchor to the price level that will restore greater stability to prices as well as exchange rates. But much of the support is based on an idealized view of the gold-standard era as an age of unmatched economic progress and monetary stability. In fact, while the United States was on a gold standard for most of the time from 1834 to 1933, there were alternating periods of deflation and inflation. And in Japan, the deflationary policies pursued in the second half of the 1920s to return to the gold standard reduced real farm income by about one-third and contributed to the country's political problems.

Most economists agree that gold is too speculative a commodity on which to base monetary policy. The price of gold is sensitive to many factors, such as political disorder, that make it difficult to maintain the equivalence of gold and currency at a fixed price. An effective gold standard requires an adequate and steady growth in the monetary stock of gold to promote economic growth. The major suppliers of gold, however, are the Soviet Union and South Africa, neither of which for political reasons can be considered reliable sources.

There is more support for reforms along the lines of the Bretton Woods system, which emerged in response to the breakdown of the gold standard and the chaos of the 1930s. The 1944 Bretton Woods Conference of 44 nations established exchange rates pegged to the U.S. dollar, which was in turn pegged to gold at the price of $35 an ounce. Countries were expected to follow economic policies that maintained their currency's value at the specified level and intervene when it got out of line. But in practice, there were frequent devaluations, since countries were allowed to alter exchange rates when it became clear that balance of payments deficits were not temporary in nature.

Bretton Woods was basically an agreement that the United States would maintain domestic stability and other countries would peg their currencies to the dollar and accumulate their reserves in gold-convertible dollars. As noted above, this meant that governments surrendered effective control of monetary policy. In 1969, for example, Germany experienced a 25 percent increase in its money supply in a single week.

The United States was willing to endure several recessions in the 1940s and 1950s to assure the stability of the dollar. But in the 1960s, the decision to pursue both the war in Vietnam and the war on poverty overrode economic considerations. Finally, worldwide inflation overwhelmed the political will to maintain fixed rates. But it is probable that the Bretton Woods system would have broken down sooner or later even without the burst of inflation. With the overvalued dollar leading to the accumulation of dollar reserves abroad relative to the U.S. gold stock, the dollar convertibility of gold became increasingly doubtful. The decline in the U.S. gold stock from $23.4 billion in 1949 to $10.1 billion in 1971 led to the decision to end the covertibility of dollars.

Support for a new Bretton Woods system reflects in part a nostalgia for the impressive growth and stability of that period, without recognizing that the problems that caused the downfall of fixed exchange rates still exist. In the 1960s, major industrial countries did experience faster growth and less inflation than under the floating exchange rate system (see Table 6). But the two periods differ in many respects other than the exchange rate regime. Rapid growth in Europe and Japan in the 1960s was part of the process of catching up after World War II, while two major oil market shocks came in the 1970s. Moreover, exchange rates in the latter period have not been allowed to float cleanly, as prescribed by advocates of floating, as governments have used various methods to manage exchange rates.

The pressures created by large U.S. budget deficits during the past five years would have broken down any fixed exchange rate system. The rise of the dollar has acted as an equilibrating mechanism enabling the current account balance to adjust to satisfy the U.S. appetite for capital. Under a fixed exchange rate system, the likely remedy for the high dollar -- easy money -- would have brought a return of high inflation rates. Floating exchange rates have probably absorbed the shocks of the last 15 years better than any fixed rate regime.

Table 6: Economic Performance of OECD Countries

(in percent)

	1960-69	1970-72	1973-82
Average real GNP growth rate	4.95%	4.12%	2.45%
Average inflation rate	2.84	5.20	9.88
Average unemployment rate	2.73	3.40	5.34

Source: Jeffrey R. Shafer and Bonnie E. Loopesko, "Floating Exchange Rates after Ten Years," Brookings Papers on Economic Activity, 1:1983, p. 6.

Proposals For Target Zones

Given the frustration with floating rates and the difficulty of returning to fixed rates, some analysts have proposed a compromise: target zones. There is support for this proposal, both as a first step toward fixed rates and as an arrangement superior to fixed rates -- which some economists view as incompatible with the free movement of capital.

In contrast to the September 1985 G-5 agreement, which decided that certain exchange rates were wrong, target zone schemes specify which rates are correct. Some advocates of this approach claim that only managed rates can prevent the misalignment of real exchange rates that occurs under both fixed and floating regimes. The Institute for International Economics' John Williamson suggests that financial authorities establish wide currency ranges, such as plus or minus 10 percent, that are not clearly wrong. These ranges, he believes, should be continuously readjusted to account for differing rates of inflation. In contrast to this approach, which in effect sets zones for real exchange rates, Ronald McKinnon of Stanford University favors target zones for nominal exchange rates. This proposal, which is sometimes referred to as "global monetarism," is a more ambitious plan that would not allow divergent rates of inflation. The inherent weakness of both plans, though, is that they would rely on the willingness of governments to change domestic economic policies when a currency threatens to break out of the accepted range.

Advocates of target zones cite the European Monetary System, which links the currencies of eight countries, as a model for a global system. The EMS requires each government, with the exception of Italy, to keep its currency within 2.25 percent of the target level. The system has been surprisingly stable since its creation in 1979. Despite the sharp appreciation of the dollar, the devaluation of the French franc last month was the first realignment in currencies in three years. The EMS has been successful because its members have been willing to link their currencies and policies to West Germany's, resulting in a convergence of inflation rates. Five years ago, inflation in EMS member countries ranged from 5 percent to 22 percent; that spread has now narrowed to 0.1 percent to 7.6 percent.

Support for this type of system includes congressional Democrats, who in this year's annual report of the Joint Economic Committee called on the administration to establish a target zone system. But last April, the IMF's interim committee rejected a proposal for target zones. West Germany, in particular, is an outspoken opponent of proposals to link the dollar, yen and EMS currencies because it fears that such an arrangement might force Bonn to accept a higher rate of inflation. Many Europeans believe that the United States does not pay sufficient attention to the interests of foreign countries in setting its economic policy. If it cannot even produce a budget to serve its own interests, they argue, it is unlikely to fulfill fiscal promises to foreigners.

A major complication of these schemes is the establishment of appropriate target zones. The disagreement at the Tokyo summit over whether the dollar had fallen sufficiently illustrates the difficulty of reaching agreement on currency values. In February, in fact, the two chief financial officers of the U.S. government, Federal Reserve Board chairman Paul Volcker and Treasury Secretary James Baker, disagreed over the appropriate level for the dollar. Economists as well as politicians have diverse opinions on the right exchange rate. Mr. McKinnon, for example, believes that a rate of Y200=$1.00 would achieve purchasing power parity, while Brookings Institution economist Edward Bernstein argues that a rate of Y120=$1.00 is appropriate.

Setting exchange rates that will equilibrate trade balances is difficult in practice, since economists are unsure of the timing and impact of exchange rates on trade. The issue is further complicated by the uncertainty over how policy changes influence currency values. For example, the U.S. budget deficit has long been blamed for the overvalued dollar, but a reduction in that deficit might increase confidence in the U.S. economy and strengthen the dollar by encouraging capital flows into the country.

Conclusion

The Treasury Department, which is continuing to study the possibility of an international monetary conference, plans to reach a decision by the end of the year. Legislators as diverse as Rep. Kemp and Sen. Bill Bradley (D, N.J.) support reform; most of the comprehensive trade bills under consideration call for a monetary conference. In addition to France, Prime Minister Yasuhiro Nakasone, who favors "managed flexibility" rather than target zones, has indicated his support for a monetary conference.

If the plan agreed to at the summit is successful, it will reduce the support for a global conference. But many economists doubt that the plan will have much impact. With no enforcement mechanism other than peer pressure and public opinion, it is an open question whether or not the agreement will improve policymaking and enhance currency stability. Over the last five years, for example, the United States has largely ignored international pressure to reduce its budget deficit.

While there is a consensus in favor of more stable exchange rates, there is less agreement on how to achieve it. The debate centers on whether it is better to first set exchange rates and then coordinate economic policy in order to maintain those rates or to first synchronize policies to achieve stable rates. Advocates of setting rates first argue that it would provide a catalyst for the timely adoption of sound economic policies. Instead of allowing currency misalignment to force corrective action, they argue, setting target zones would discourage policies that lead to an over- or under-valued currency by forcing governments to take into account international as well as domestic considerations. If a government had to explain what impact its fiscal policy had on exchange rates, for example, it might lead to better policy decisions.

But since macroeconomic policies, particularly fiscal policy, have been the major cause of misaligned currencies during the past few years, policy reform appears a more sensible solution than an overhaul of the international monetary system. If government policies converge, exchange rates will be sufficiently stable, whether they are fixed, floating, or somewhere in between. But if policies are not in harmony, rates will be unstable regardless of the rules. Disruptive exchange rate changes are usually the consequence rather than the cause of economic problems. To blame floating exchange rates for the world's economic problems is like blaming the messenger for bringing bad news. If currencies were somehow fixed, the results of poor policy would be likely to show up elsewhere where they could be harder to deal with.

The harmonization of policies necessary to maintain stable exchange rates requires that governments surrender a degree of policy autonomy. Even though the needed policy changes may be in their best interests, most countries are reluctant to yield economic sovereignty. When the rules become too hard to live with, nations tend to change the rules rather than the policy.

The G-5 agreement reflected a convergence in the interests of the major nations: the high dollar was fueling protectionism in Congress while European and Japanese investment capital continued to flow into the United States. But already the consensus on exchange rates has broken down and some countries remain reluctant to coordinate policies. At the summit, for example, West Germany agreed to the plan proposed by the United States on the condition that it would not be implemented mechanically or automatically, stimulating Germany's economy against its wishes.

The lack of consensus among nations makes it clear that an overhaul of the current system is unlikely in the near future. Moreover, the tenuousness of government control over the central bank in many countries further complicates the task of coordination. At the same time, though, conditions are ripe for constructive changes, given the frustration with floating rates and the relative convergence of economic conditions in major industrial countries. Change is likely to come gradually as governments realize that stable, consistent policies leading to stable exchange rates are preferable. Having seen the costs of acting independently, perhaps political leaders will be better able to coordinate their policies and encourage stability in the international monetary system.

For further information, contact Randall S. Jones.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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Ground Rules For House Trade Debate Determined

The House of Representatives on May 15 approved complicated ground rules for consideration of HR 4800, the omnibus trade package. The arrangement, devised under Rules Committee auspices, provides Republicans with one more chance to influence legislation that has borne a distinctively Democratic signature. The debate will also resolve several long-standing jurisdictional battles over control of trade-related matters between rival committees.

Under what is technically termed a "modified open-rule," general debate on the Trade and International Economic Policy Act of 1986 will be limited to three-and-a-half hours. One hour will be ceded to sponsoring and opposing members of the Ways and Means Committee, with consecutive half-hour slots provided to members of some six other panels so that they may control debate on pertinent sections. The rule also automatically accepts some corrections to

- Compilation of a supplementary budget - The prospects for a stimulative supplementary budget being passed this fall are increasing. Many Liberal Democratic Party members are pushing hard for new public works projects, and Mr. Nakasone is also inching toward such a position.

There is a growing consensus that even measures such as these are only stopgaps. Press sources said that LDP, business and labor leaders who met May 19 to discuss the yen-impact situation, agreed that perhaps the essence of the controversial Maekawa report -- which argues that Japan must re-orient its economy toward stimulating and meeting domestic demand (see JEI Report No. 13B, April 4, 1986) -- is correct. It was also agreed, however, that temporary adjustment measures, like the low-interest loan program, are necessary. U.S. officials are likely to be pleased with the first consensus but opposed to the second. Japanese policymakers are therefore preparing for plenty of summer heat, both domestic and foreign.

Jon Choy

Dollar Reverses Course -- At Least For Now

Treasury Secretary James Baker's comments on exchange rates last week helped reverse the dollar's downward trend -- at least temporarily. After hitting its eighth record low against the yen in 14 days May 12, the dollar rose nearly 5 percent to close at Y168.15=$1.00 May 19. It was also buoyed by calls from Prime Minister Yasuhiro Nakasone and West German central bank president Karl Poehl for coordinated intervention to prop up the dollar.

Mr. Baker, appearing May 13 before Senate trade and banking subcommittees, noted that the dollar has more than fully offset its earlier appreciation against the yen. While repeating that the administration has no target for the exchange rate, he said that he was concerned about "unwarranted interpretations that the market sometimes attaches to [such] statements." Mr. Baker's comments mark the first attempt by the administration to slow the dollar's slide since the Group of Five agreement last September to lower its value.

The Treasury Secretary's comments may reflect increasing concern that foreign capital will pull out of the U.S. market if the dollar's decline continues. This fear has been widely expressed by Federal Reserve Board chairman Paul Volcker, who said that the dollar's May 12 plunge below the Y160 level "doesn't make me happy." Some analysts had predicted that Japanese investors would sell more U.S. securities than they purchased in April, but there is little evidence thus far that the Japanese have lost their appetite for U.S. Treasury offerings. According to the Institute for International Economics, the Japanese invested a record $10 billion in American securities last month, up from the $6 to $7 billion a month that had been the norm. At the May 8 auction, press reports said that Japanese investors bought $5.5 billion worth of 30-year bonds and $2.5 billion in 10-year bonds, roughly twice the amount they purchased in February.

The dollar's rebound is likely to be limited by the sluggish U.S. economy and continuing large trade deficit, which Mr. Baker predicted would remain at about $125 billion this year on a balance of payments basis (both exports and imports valued f.o.b.) before dropping to $100 billion next year.

International Trade and Industry Minister Michio Watanabe said he expects the yen to stabilize between Y160-Y165=$1.00. Commerce Secretary Malcolm Baldrige, however, indicated his support for a further fall in the dollar, noting in congressional testimony May 14 that the dollar's decline against the yen had not been excessive and commenting that a further depreciation would not increase inflation.

Tokyo has no plans for a fourth cut in the official discount rate, according to Bank of Japan governor Satoshi Sumita. While the strong yen will slow growth somewhat, Mr. Sumita said he does not believe that it will have a major impact. Many business leaders are less optimistic. Noboru Gotoh, president of the Japan Chamber of Commerce and Industry, said that the strong yen had hit small businesses particularly hard. Small firms, which employ 80 percent of Japan's workforce, face declining exports and stiff rivalry in domestic markets, particularly from the newly industrialized countries. The yen's sharp appreciation relative to the currencies of Korea, Taiwan, Hong Kong and Singapore (see Table) will result in increased competition for many Japanese firms.

Yen's Appreciation Relative to the Currencies of the Newly Industrialized Countries

Currency	September 2, 1985 to May 13, 1986	January 13, 1986 to May 13, 1986
Korean won	60.7%	30.7%
Taiwan dollar	42.4	18.8
Hong Kong dollar	46.5	24.5
Singapore dollar	44.1	30.4

Source: Nihon Keizai Shimbun, May 15, 1986.

Randall S. Jones

NTT's First-Year Performance

With Y780 billion ($4.7 billion at Y165=$1.00) in capital and 310,000 employees, Nippon Telegraph and Telephone Corp. is Japan's largest private corporation. Businessmen and investors have watched NTT closely in its first year as a private company. The telecommunications giant surprised even its own president by tentatively reporting a record profit for the year ending March 31, 1986. Although it is like comparing apples to oranges, NTT's performance compares favorably with American Telephone & Telegraph Co.'s 1985 results. Both have actively diversified operations to achieve growth but their approaches have been different.

While NTT has not released detailed figures, first-year operations look like a resounding success. In November 1985, NTT president Hisashi Shinto reported a total of Y2.5 trillion ($15.1 billion) in operating revenues in the first six months of private activity. This yielded an ordinary profit of Y170.6 billion ($1 billion) and an after-tax profit of Y76.9 billion ($466 political scene since his crippling stroke last year. Mr. Takeshita appears poised to inherit the bulk of the Tanaka faction, which provided the backing necessary for Mr. Nakasone to remain in office so long. The one remaining question is whether Mr. Nakasone can muster enough strength to help determine his successor -- and thus perpetuate his own influence -- should he decline to make a bid for a third term.

Michael W. Chinworth

Notes

o At JEI press time, President Reagan announced that imports of seven types of machine tools from Japan as well as from three other suppliers would be limited for up to five years through the negotiation of restraint arrangements. The May 20 decision came as little surprise since some form of assistance for American machine tool builders had been in the works for the past two months. What was unclear was whether the administration would tailor its long-delayed response to the industry's campaign for across-the-board protection from foreign competition on national security grounds in such a way to score points with Congress. The answer, delivered just hours before the House began consideration of a Democratic-authored comprehensive trade bill that administration officials have called unacceptably protectionist (see articles in this issue), was a decided yes.

The White House admittedly did not go as far as the National Machine Tool Builders' Association proposed in its March 1983 complaint -- a rollback in aggregate imports to 17.5 percent of the U.S. market for five years, with imports in 18 product lines capped at 20 percent of domestic sales. But this plan, as candid industry executives will acknowledge, was doomed from the start. Instead, American machine tool builders got the next best thing from a deeply divided administration. The four countries with which restraint agreements will be negotiated -- Japan plus West Germany, Taiwan and Switzerland -- supply roughly three-fourths of total U.S. imports, while the seven product lines targeted for restriction -- machining centers, numerically controlled lathes, milling machines and shearing and punching machines, and other lathes, milling machines and shearing and punching machines -- account for approximately half of all purchases from abroad.

Although the thrust of the White House's strategy is obvious, specific negotiating objectives are still in short supply. In particular, it is not known for certain how far back Washington will try to roll imports, although there is some indication that 1981 import levels are the goal. If true, this would mean a 16.3 percent cut for Japan (see Table), the dominant foreign supplier with 21.6 percent of the overall U.S. machine tool market last year. Uncertain as well is whether the restraint arrangements will be based on volume or value; so is the starting date for the agreements. What is clear, though, is that Japan and the other suppliers have six months to come to terms with Washington. Footdragging could result in a formal finding that machine tool imports are a threat to this country's national security and a decision to slap quotas on shipments -- a move President Reagan put on hold for the time being.

U.S. Imports of Machine Tools from Japan, 1981-85

(in millions of dollars, Customs value)

	1981	1982	1983	1984	1985
Machining Centers	$183.9	$168.1	$151.4	$227.0	$295.8
Numerically Controlled Lathes	258.6	179.4	95.5	169.6	217.6
Other Lathes	44.9	23.6	9.6	11.7	20.5
Numerically Controlled Milling Machines	16.3	8.1	6.4	10.3	46.7
Other Milling Machines	19.7	11.6	6.2	7.7	
Numerically Controlled Shearing and Punching Machines	16.3	14.9	12.6	33.6	72.6
Other Shearing and Punching Machines	7.1	6.7	6.5	9.1	
Subtotal	546.8	412.4	288.2	469.0	653.2
Total Imports from Japan	693.0	532.9	406.6	658.1	839.4

Source: U.S. Department of Commerce, U.S. Imports for Consumption and General Imports (FT 246) -

o The four-month search for candidates for a new round of MOSS (market-oriented, sector-selective) negotiations has come to a temporary end (see JEI Report No. 16B, April 25, 1986). Making a politically expedient U-turn, Tokyo announced May 7 that automotive parts and "other transportation-related" issues would be the next focus of the high-level sectoral talks.

Parts were on early State Department/Foreign Ministry lists of possible negotiating targets, but this product group was initially vetoed by other agencies in both governments. Ministry of International Trade and Industry officials argued that parts were an inappropriate subject for the sectoral talks since formal barriers were not the cause of whatever problems American manufacturers had in selling production components to Japanese automotive makers. They noted as well that the procurement policies of Japan's car and truck producers were already scheduled to be discussed in another bilateral forum.

With the Commerce Department taking a similar position at first, the search for an agenda for the second round of MOSS negotiations moved off in other directions, but these forays also encountered roadblocks. Worried that the lack of progress might provide additional ammunition for a protectionist-minded Congress, Foreign Ministry officials did some bureaucratic arm-twisting and produced agreement on automotive parts as the next subject of the sectoral talks.

o Two highly protectionist merchant marine provisions have missed inclusion in the omnibus trade bill pending in the House. The Merchant Marine and Fisheries Committee approved HR 3655 without amendment May 15. The measure requires a percentage of automotive exports from Japan to be transported on U.S. flag carriers (see JEI Report No. 17B, May 2, 1986). A formal report

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JEI REPORT

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Tokyo Adopts Additional Measures To Stimulate Economy

On May 30 Tokyo adopted emergency measures to cushion the economy from the deflationary impact of the strong yen. This step followed the pump-priming measures announced April 8 (see JEI Report No. 15B, April 18, 1986), which assumed that the dollar would stabilize at about Y180=$1.00. Takao Akabane, an official of the Economic Planning Agency, downplayed the package, however, noting that "We cannot expect these measures to have [as] big [an] impact on the gross national product as the April 8 package."

Last week's move calls on three government financial institutions to cut interest rates on loans to small and medium-sized firms. (The current budget

Japan Is Top Net Creditor Nation

The Ministry of Finance reported last week that Japan replaced Britain in 1985 as the world's largest net creditor nation. Japan's official and private foreign assets exceeded liabilities by $129.8 billion at the end of 1985, compared to $74.4 billion a year earlier (see Table 1). The sharp rise in net external assets resulted from Japan's huge $56 billion trade surplus last year, much of which was invested in U.S. government bonds.

Table 1: Japan's Net External Assets

(in millions of dollars)

End of Year	Private Sector	Government Sector	Total
1978	-$2,550	$38,764	$36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821

Source: Bank of Japan and Nihon Keizai Shimbun, May 27, 1986.

Japan's net assets have increased substantially since 1981, when the private sector had net liabilities of more than $18.5 billion. Japan has overtaken Britain and West Germany, whose net external assets were about $90 billion and $50 billion, respectively, at the end of 1985. In the wake of its huge trade deficit, the United States became a debtor nation last year for the first time since World War I, with net liabilities of about $60 billion.

Japan's external assets increased 28.3 percent to $437.7 billion last year, while liabilities rose 15.4 percent to $307.9 billion (see Table 2). The increase in liabilities was largely a result of short-term commercial borrowing from abroad, corporate bond offerings in overseas markets and foreign purchases of Japanese government bonds.

Holdings of foreign securities, which rose 66.4 percent to $145.8 billion, now account for one-third of gross foreign assets. Portfolio investments are concentrated mainly in bonds; net purchases of foreign equities totaled only $1.2 billion in 1985 compared to bond purchases of $53.5 billion. American securities were popular last year despite the declining dollar, accounting for 86 percent of total overseas purchases, an increase from 75 percent calculated by Salomon Brothers Inc. in 1984. Although Japanese purchases of U.S. corporate bonds quadrupled to $2.9 billion last year, according to Daiwa Securities America Inc., Treasury bonds remain the most important financial instrument, accounting for about four-fifths of total purchases of foreign securities. Japanese investors funded about one-third of this country's budget deficit last year and are estimated to hold about $100 billion in Treasury bonds.

Table 2: Japan's External Assets and Liabilities

(in millions of dollars)

	Assets		Liabilities	
	End of 1984	End of 1985	End of 1984	End of 1985
Long-Term	$229,184	$301,297	$113,222	$122,328
Private Sector	191,946	264,458	83,738	91,776
Direct Investments	37,921	43,974	4,458	4,743
Trade Credits	22,824	23,603	24	131
Loans	40,601	46,870	1,266	1,211
Securities	87,578	145,748	77,081	84,847
Others	3,022	4,263	909	844
Government Sector	37,238	36,839	29,484	30,552
Trade Credits	1,189	1,062	103	84
Loans	24,491	23,293	29,381	30,468
Others	11,558	12,484	0	0
Short-Term	112,024	136,404	153,640	185,552
Private Sector	84,761	108,753	145,900	176,985
Monetary Movements	77,562	99,719	130,098	160,984
Others	7,199	9,034	15,802	16,001
Government Sector	27,263	27,651	7,740	8,567
Monetary Movements	27,261	27,650	3,590	4,557
Others	2	1	4,150	4,010
Total	341,208	437,701	266,862	307,880

Source: Nihon Keizai Shimbun, May 27, 1986.

Japan's direct foreign investment assets rose 16 percent to $44 billion in 1985. A notable trend has been the shift of direct investment to developed countries, particularly the United States. During FY 1985, the United States and Canada accounted for 45 percent of Japanese direct investment, while Asia's share dropped to 12 percent, partially as a result of a withdrawal from Hong Kong and diminished investment in China. Moreover, the outflows of funds to the Middle East plummeted 83 percent, while direct investment in Africa fell by one-half.

Despite the rapid increase in Japan's overseas direct investment, it accounts for only 10 percent of gross external assets, considerably below the 26 percent level of the United States and West Germany's 14 percent. The Maekawa Report (see JEI Report No. 13B, April 4, 1986) called for a doubling over the next seven years of net direct foreign investment as a share of gross domestic product. In addition, an advisory committee to the Minister of International Trade and Industry recently called for an annual 12 percent increase in overseas direct investment to reduce Japan's trade surplus to $2 billion in the year 2000. Such an increase, the committee estimated, would create nearly 2 million jobs abroad at the expense of 560,000 jobs in Japan.

In terms of gross external assets, Japan still trails the United States and Britain, which had $914.7 billion and $712.2 billion, respectively, at the end of 1984. But Japan's total is likely to expand rapidly as its trade surplus increases this year and businesses step up direct investment abroad to bypass the impact of the strong yen.

Randall S. Jones

Curtain Rises On Special Session; Stage Set For Double Election

Officially, Japan's Diet is meeting in a special session to consider emergency measures to help companies hard hit by the yen's appreciation. However, most observers of the political scene agree that the more pressing reason for the gathering is that it will enable the cabinet to dissolve the lower house, a parliamentary maneuver necessary if the Diet is to hold double elections in early July.

These developments mark a significant political victory for incumbent Liberal Democratic Party president Yasuhiro Nakasone, who has favored calling double elections for the Diet, both to strengthen the ruling party and to enhance his own influence in the party's inner circle. But because the Supreme Court had ruled that the apportionment of lower house seats was unconstitutional, the prime minister was stymied until the Diet approved a realignment in the final moments of the regular session, which ended May 22 (see JEI Report No. 19B, May 16, 1986).

The electoral reform legislation, however, also prohibited lower house elections for 30 days after the effective date of the bill, which meant that the prime minister could not call elections immediately after the regular session concluded. In response, Mr. Nakasone pressed ahead with an alternative plan to neutralize the 30-day ban by calling a special session of the Diet, renewing his option for twin balloting. Although opposition parties and Nakasone rivals adamantly opposed the proposal, some senior LDP officials reportedly backed the idea because they felt the timing would be advantageous. In 1980, the last time a double election was held, turnout increased dramatically and swept the LDP into the Diet with its strongest showing in years. A key figure in the succession race, Finance Minister Noboru Takeshita, also apparently agreed with this logic and came out in favor of the plan at the last minute, feeling that the results could strengthen both the party and his own political position.

Stretching out the date of the elections also helps place some distance between Mr. Nakasone and his less-than-ideal performance at the Tokyo summit. Although his political opponents could be expected to be critical under any circumstances, the summit was far from the political success the prime minister had sought to justify his continuation in office.

It is clear that Mr. Nakasone would like to retain his influence as long as possible, if not by extending his term in office then by influencing the

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REPORT

NO. 22A June 13, 1986

THE JAPANESE ECONOMY IN 1985

Summary

While overall growth of gross national product was not as high as the previous year, the Japanese economy continued to expand at a better pace than its U.S. counterpart in 1985. In addition, the pattern of growth was more even, as the economy moved from the recovery phase to the expansion stage.

Foreign demand was again responsible for nearly one-third of the economic stimulus, either directly via trade in goods or indirectly through investments by export-oriented firms. Domestic demand did improve over 1984's level, rising from 62 percent to 71 percent of overall growth. Japan enjoyed a record trade surplus and a long-term capital deficit for the second year in a row, eliciting a mixed response from its trading partners. Tokyo sought non-Keynesian remedies with greater energy but less success.

Overview of GNP Growth

Japan's gross national product grew a solid inflation-adjusted 4.6 percent in 1985, a decline from the previous year's 5.1 percent that can be ascribed to the slowing growth of exports (see Table 1). The performance precisely matched the government's initial estimates for FY 1985 made in late 1984, although lower-than-expected third quarter growth caused some concern. Japanese officials were not displeased with the economy's performance, which they asserted represented a shift from recovery to expansion.

This observation is borne out by the fact that all but one of the components of GNP made a positive showing. More importantly, residential housing demand revived (exceeding the Economic Planning Agency's 3.1 percent forecast for FY 1985), while business investment grew even faster than the planning agency's projected 8.5 percent rate. The EPA was disappointed, however, by stagnant consumer spending. The agency had originally hoped for 4.1 percent growth in this largest component of GNP during the April 1985-March 1986 period, but after a good start in the first quarter, expansion fell to just half of the expected rate.

EPA was also unpleasantly surprised to see its estimates of current account and trade account balances turn out to be off the mark. Instead of a trade surplus of approximately $44 billion and a current account surplus of $34 billion, Japan rang up balances of $56 billion and $49 billion, respectively. Although the growth of exports was only about one-third of 1984's rate, import expansion nearly came to a halt, resulting in 30 percent-plus growth in the net external sector.

The quarterly growth record was as erratic in 1985 as it had been in the previous 12 months, changing by more than 50 percent each period. Much of the unevenness can be traced to the seasonal pattern of foreign trade and residential construction, but private investment also played a role as it surged in the second quarter before settling down at a still fast pace for the remainder of the year.

Personal Consumption - Japanese consumers remained tight-fisted during 1985; growth held steady at just above 2 percent for most of the year. Only the first quarter's 4.8 percent showing prevented 1985's overall expansion rate from falling more than 0.1 percentage point from the previous year. When the final three quarters are factored in, consumer spending as a share of GNP fell for the second consecutive year from 56.9 percent to 55.8 percent.

This trend vexed policymakers since consumers again failed to respond to positive developments. As in 1984, average wage and semiannual bonuses increased 4.5 percent; overtime hours were up; second incomes rose an average 2.8 percent; and disposable income grew a solid 4 percent. Although this last gain was less than 1984's 4.4 percent expansion, inflation was slightly lower in 1985 at 2.1 percent, meaning that the growth of real disposable income was fairly close in both years -- 1.9 percent last year versus 2.2 percent.

The situation is even more puzzling when average household spending is analyzed. Of the Y14,340 ($84.35 at Y170=$1.00) nominal increase in monthly disposable income, 6.6 percent was spent on clothing; 5 percent on increased transportation costs; 4.9 percent on food; 4.5 percent on recreation, 3.4 percent on furniture; 3 percent on education; 1.4 percent on housing costs; 0.6 percent on utilities; and 18.3 percent on miscellaneous expenditures. When compared with 1984's data (see JEI Report No. 16A, April 26, 1985), these increases are all significantly smaller. This reduction in the average household rate of spending growth meant that more money was saved. And indeed, savings accounted for a whopping 46.8 percent of the increase in disposable income, compared with 1984's share of just 0.4 percent.

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Table 1: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	1984	1985	January-March 1985	April-June 1985	July-September 1985	October-December 1985
Gross National Product	Y278,118.6 (5.1%)	Y291,039.3 (4.6%)	Y285,425.7 (1.7%)	Y289,447.6 (5.8%)	Y291,588.4 (3.0%)	Y296,667.1 (7.2%)
Personal Consumption Spending	158,124.5 (2.8%)	162,439.9 (2.7%)	161,106.4 (4.8%)	161,900.4 (2.0%)	162,777.8 (2.2%)	163,650.2 (2.2%)
Private Residential Construction	13,619.1 (-2.1%)	14,056.2 (3.2%)	13,913.9 (5.1%)	14,227.9 (9.3%)	13,881.0 (-9.4%)	14,186.5 (9.1%)
Private Fixed Nonresidential Investment	46,277.4 (10.9%)	52,114.8 (12.6%)	48,574.5 (1.0%)	51,124.5 (22.7%)	53,189.7 (17.2%)	55,300.4 (16.8%)
Change in Business Inventories	1,609.6 (102.3%)	1,812.7 (12.6%)	2,112.0 (37.4%)	1,825.3 (-44.2%)	1,438.2 (-61.4%)	1,882.1 (193.3%)
Government Current Expenditures	26,471.3 (2.5%)	27,146.9 (2.6%)	26,979.1 (4.6%)	27,081.5 (1.5%)	27,192.9 (1.7%)	27,342.9 (2.2%)
Government Fixed Investment	22,374.4 (-2.9%)	20,831.2 (-6.9%)	21,615.5 (-7.1%)	19,954.0 (-27.4%)	20,495.6 (11.3%)	20,917.3 (8.5%)
Change in Government Inventories	162.8 (*)	305.9 (*)	27.9 (*)	77.6 (*)	515.6 (*)	604.7 (*)
Net External Sector	9,479.7 (59.3%)	12,331.7 (30.1%)	11,096.4 (-29.2%)	13,256.4 (103.7%)	12,097.6 (-30.6%)	12,783.0 (24.7%)
Exports of Goods and Services and Factor Income Received	52,365.0 (17.5%)	55,446.5 (5.9%)	54,833.7 (-3.0%)	57,176.9 (18.2%)	55,077.6 (-13.9%)	54,654.4 (-3.0%)
Imports of Goods and Services and Factor Income Paid	42,885.3 (11.1%)	43,114.9 (0.5%)	43,737.3 (5.5%)	43,920.5 (1.7%)	42,980.0 (-8.3%)	41,871.4 (-9.9%)

*Cannot be calculated or meaningless.

Note: Beginning with third quarter figures, real growth rates are expressed in terms of 1980 yen rather than 1975 yen. The accounting change is a normal updating procedure, and has the effect of reducing 1981-1984 overall real GNP growth rates to 3.3 percent, 3.2 percent, 3.7 percent and 5.0 percent, respectively.

Source: Economic Planning Agency

As a consequence, gross savings rose to an average of 22.5 percent of nominal disposable income, compared with 1984's 21.3 percent mark. The remainder was distributed among basic needs (housing, 3.7 percent; food, 19.9 percent; utilities, 4.6 percent; transportation, 7.5 percent; medical expenses, 1.8 percent; education, 3.3 percent) and discretionary expenses (furniture, 3.3 percent; clothing, 5.4 percent; recreation, 6.8 percent; miscellaneous expenses, 21.3 percent), virtually all below the previous year. It is obvious to Japanese officials that they have not yet found the right combination of incentives to induce consumers to open their pocketbooks.

Private Residential Construction - The housing industry continued the upswing that began in the second half of 1984 with a 3.2 percent showing, its best contribution since 1978. Despite a dip in the third quarter, 1,236,072 new housing units were started, a 4.1 percent gain. The average floor area of each new residential unit shrank to 83.4 square meters from 84.4, but the average price of a unit rose a shocking 34.5 percent. The number of rental units started (527,042) exceeded the number of new units for sale (464,697) for the first time in 1985, perhaps reflecting the sharp price increase.

In response to this trend and to stimulate the domestic economy, Tokyo in October increased the number of low-interest mortgages issued by the semipublic Housing Loan Corp. by 20,000 to a total of 510,000 for fiscal 1985. In addition, the government accelerated auctions of its land holdings in urban areas to stimulate new construction. Falling interest rates are likely to add to this stimulus, further brightening the outlook for 1986.

Private Nonresidential Investment - Capital investment continued to boom in 1985, putting in a second consecutive year of double-digit real growth. The contrast between the first and second quarters of 1985 is particularly stark: the annualized rate jumped from 1 percent to almost 23 percent. The sustained high rate of investment in the latter half of the year proves that the second quarter was not a fluke.

On a sectoral basis it appears that some of 1984's hot performers cooled off, and instead investment growth was distributed throughout the economy (see Table 2). Investment by firms in the electronics, nonelectric machinery and glass and ceramics sectors slowed dramatically from year-earlier rates. On the other hand, capital spending by automotive makers, chemical producers and service companies experienced strong upturns. Rationalization in the wood, paper and shipbuilding industries continued at a high rate.

Change in Inventories - The erratic behavior in inventory changes reflected continued vigorous production and shipment activities. Following the usual pattern during a recovery, inventories were drawn down in the summer and fall to meet rising holiday orders and rebuilt during the winter and spring months. With all industries operating at 102.2 percent of 1980 capacity levels, the large quarterly changes were understandable.

Public Sector - For the fourth year, the government's contribution to economic growth was negligible. The 4.6 percent bulge in outlays in the first quarter resulted from the supplemental budget passed in December. (The first quarter of calendar 1985 was the last quarter of fiscal 1984.) The true impact of Prime Minister Yasuhiro Nakasone's fiscal austerity policy was obvious from

Table 2: Capital Investment by Sector, FY 1984-FY 1985

(in billions of yen; percentage change)

	FY 1984 (Actual)		FY 1985 (Estimated)	
All Industries	Y21,928.0	11.6%	Y23,910.3	9.0%
All Manufacturing	9,887.0	18.3	10,706.4	8.3
Foods	583.7	-1.0	603.3	3.4
Textiles	196.1	30.2	201.0	2.5
Paper and Pulp	368.3	88.8	445.0	20.8
Chemicals	1,281.5	4.0	1,438.0	12.2
Oil and Coal	274.9	-1.8	298.4	8.5
Rubber and Leather	161.2	40.3	181.2	12.5
Ceramics	412.2	34.5	446.2	8.2
Steel	809.2	-16.1	840.5	3.9
Nonferrous Metals	290.0	34.7	336.5	16.0
Metal Products	280.3	7.6	295.1	5.3
Nonelectric Machinery	535.8	25.5	576.2	7.5
Electric Machinery	2,552.2	47.9	2,397.7	-6.1
Transportation Machinery	1,258.8	-2.2	1,703.1	35.3
Automobiles	954.5	5.0	1,363.9	42.9
Ships	55.9	-10.2	62.4	11.7
Other	248.4	43.5	276.8	11.4
Precision Machinery	286.0	16.6	335.4	17.3
Printing and Publishing	314.4	10.7	323.7	3.0
Other Manufacturing	282.3	26.5	285.0	1.0
All Non-manufacturing	12,041.1	6.6	13,203.9	9.7
Agriculture	25.3	-31.8	35.1	39.0
Mining	231.7	-5.7	173.4	-25.2
Construction	318.8	-4.0	286.4	-10.2
Wholesaling and Retailing	1,267.3	14.6	1,352.3	6.7
Wholesaling	608.5	12.9	615.7	1.2
Large Retailers	264.1	-11.2	301.7	14.2
Other Retailers	394.7	46.5	434.9	10.2
Finance and Insurance	571.4	10.2	575.4	0.7
Real Estate	1,006.1	15.0	1,150.0	14.3
Transportation and Communications	1,407.5	1.1	1,613.7	14.6
Private Railways	321.0	12.4	360.3	12.3
Ground Transportation	330.8	2.5	441.0	33.3
Shipping	319.1	-14.4	287.2	-10.0
Other	436.7	6.3	525.2	20.3
Electric Power	3,043.5	-8.6	3,104.2	2.0
Gas	269.1	-5.4	309.8	15.1
Services	925.8	12.0	1,174.0	26.8
Leasing	2,974.6	26.7	3,429.7	15.3

Source: Economic Planning Agency

the meager showing in the remaining nine months of 1985 -- the growth of current outlays hovered around 2 percent, while fixed investment fell below the level it had recorded earlier in the year -- a drop attributable to Mr. Nakasone's efforts to balance the national budget. The Ministry of Finance, with the prime minister's support, continued to slash spending for public works and other big-ticket items in the fiscal 1985 budget. Although Mr. Nakasone is justly proud of this feat of fiscal restraint, the economic consequences have grown increasingly clear and political pressures to reverse this policy have continued to grow.

External Sector - Since the net external sector component is a residual of exports less imports, volatile activity is the norm. While 1985's overall rate of increase of 30.1 percent was hardly torpid, it was only half of 1984's blistering pace. The strong net change, however, masked a distinct softening of export growth and nearly zero growth of imports. Taken together, trade directly accounted for just above one percentage point of overall GNP growth.

Beginning in mid-1985, the strengthening yen contributed to the slower growth of exports, while a strong currency plus weak commodity prices accounted for some of the decline in the value of imports. Exports of individual products remained strong, including motor vehicles, video cassette recorders and other consumer electronics, as the expansion in the United States and the recovery in Europe continued. On the import side, purchases of crude oil and other basic inputs as well as intermediate goods rose in volume to meet investment and export demands.

Labor and Inflation

Japan's rate of unemployment declined slightly to 2.6 percent from the "high" of 2.7 percent suffered in 1984. While this level would be considered low in other industrialized nations, Tokyo was concerned over the increasing volatility of the jobless rate, which went up to 3 percent in March. Indeed, the rate dropped to 2.4 percent by July and then rose again to 2.7 percent in November. (Continuing this erratic behavior, it registered 3.1 percent in March of this year.)

Some analysts attributed this instability to the increasing use of part-time workers. While the proportion of temporary to full-time employees was up just two-tenths of a percentage point in 1985 (from 8.1 percent to 8.3 percent), the growth of part-timers continued to outstrip that of regular employees. The upward trend, however, is not out of line with changes in previous years.

Japanese workers again scored impressive gains in productivity as output per worker in the manufacturing sector rose 4.2 percent. Machinery makers contributed the biggest gain (up 7.8 percent), led by precision machinery workers (up 17.1 percent) and electrical machinery laborers (up 10.2 percent). Workers in the steel, metal products, lumber and paper industries also registered productivity gains of 4 percent or more, but this was mostly due to equipment modernization and labor rationalization cuts.

The wage picture was somewhat more controversial, for while the overall nominal wage index kept pace with productivity gains, the average real wage index again made little progress. On an industry-by-industry basis it was even clearer that workers who exhibited greater productivity growth did not necessarily benefit more than those with lower growth. Wage indices for workers in the electrical machinery and precision equipment fields, for example, showed significantly less growth than the corresponding productivity indices. The opposite situation existed for steel, mining and shipbuilding employees. This mismatch posed problems not only for labor unions but also for the government. In fact, the credibility of labor leaders has come under severe strain as they again failed to win wage hikes commensurate with productivity gains and corporate profits. The government found itself in a difficult position: it hoped that fat wage increases would be negotiated to spur domestic demand, but not so high as to threaten the nation's international competitiveness.

Inflation continued at a modest 2.1 percent pace in 1985, down slightly from 1984's 2.2 percent rate. While medical costs, educational expenses and clothing prices were up fairly strongly, food costs, which represent nearly two-fifths of the consumer price index, rose just 1.7 percent. Also helping to keep inflation in check were the limited (2.1 percent) increases in the costs of transportation and recreation -- the index's second-largest components, as well a dip in utility bills. Wholesale prices were kept solidly under wraps in 1985, actually declining 1.1 percent after dropping 0.3 percent the year before. Cheaper prices for steel, nonferrous metals, electric machinery, transportation equipment, chemicals, paper and textiles all helped turn back the clock on wholesale prices for the third year in a row.

The yen-based export price index for all commodities fell 1.4 percent, as the average price of every category fell -- except transportation equipment, which had a tiny gain of 0.3 percent. Exporters were clearly doing their best to maintain a competitive position in the face of a rising yen. Import prices showed a 2.5 percent across-the-board decline, except for (oddly enough) energy prices. Price cuts were very deep, ranging from 2.3 percent on machinery and equipment to 9.8 percent on food products. Energy prices failed to drop because of unusually high demand in winter and spring, but then steadily declined for the rest of the year.

Production and Profits

Industrial production indices underscored the strength of the expansion in 1985, with the majority of industries registering increased output. In the manufacturing sector, where production expanded 4.6 percent, electrical machinery led the way with a 11.3 percent gain. Other big gainers spanned precision equipment (16.9 percent), nonelectrical machinery (7.3 percent), transportation equipment (3.6 percent) and chemicals (3.3 percent). Industries experiencing declines included petroleum and coal (off 5 percent), lumber (2 percent), textiles (0.7 percent) and nonferrous metals (0.4 percent). In terms of types of products, capital goods rose 8.6 percent, producer goods were up 3.4 percent and consumer goods rose 5 percent (durables up 8.1 percent and non-durables gaining 2.7 percent).

Because of the varying accounting years followed by companies, the profit picture was more vague. According to Ministry of Finance projections, however, manufacturing firms showed an average 2.8 percent increase in sales for fiscal 1985, but suffered a 12.3 percent drop in earnings for the period because of a very poor second half (an assumption based on the effects of the stronger yen). Non-manufacturing companies fared a little better, according to the MOF forecast, with sales rising 6.1 percent and earnings also up 10.2 percent.

Monetary Policy

In the Finance Ministry, 1985 was another year of outward calm and inward turmoil. The Bank of Japan held a steady course on interest rates by keeping its discount rate pegged at 5 percent, and all interest rates linked to this figure, such as interest paid on small deposits and loan rates, remained steady. In this sense, monetary policy seemed to be governed by "business as usual."

The growth of the money supply (M2 + CDs) was well-behaved for three-fourths of the year, but began to expand unexpectedly beginning in October. Whereas in previous months the basic money pool had grown at 7.9 percent to 8.3 percent a month, it advanced by 8.6 percent, 9.1 percent and 9.3 percent, respectively, during the final months of 1985. This pace outstripped nominal GNP growth, putting upward pressure on prices. While inflation remained under control, BOJ officials were known to be nervous since the high money supply growth has continued into 1986. Because of the slowing economy, the central bank is loath to tighten up on the money supply and may even be forced to cut its discount rate for a fourth time in a single year. If the interest rate cut should reignite inflation instead of growth, Japan will be faced with stagflation.

In addition to this well-understood problem, financial policymakers faced many unknowns as they proceeded with the financial market deregulation program last year. It is not surprising that government agencies disagreed about plans to fundamentally change the structure of the nation's financial system. The battles fought over liberalization in 1985 revealed three factions: first, MOF internationalists anxious to bring Japan's system up to par with London and New York to compete effectively in international finance; second, BOJ and Tax Bureau officials favor who favored liberalizations, but reacted defensively about changes that would impair their ability to conduct monetary policy or collect levies; and third, the Ministry of Posts and Telecommunications, which was surprisingly vocal in defending its Postal Savings and Life Insurance and Annuity systems. (This is an understandable attitude as these accounts have assets of Y91 trillion ($535 billion) and Y28 trillion ($165 billion), respectively.) Despite this impressive opposition, MOF deregulators pushed through several important changes in 1985.

- Effective January 30, the withholding tax on interest from Euroyen instruments owned by foreigners was repealed. After heavy pressure from Washington and European capitals, MOF agreed to forego this revenue source in order to increase the attractiveness of Euroyen issues.

- Effective March 15, banks were permitted to sell money market certificates in minimum denominations of Y100 million ($588,000).

- Effective April 1, a short-term government bond market was inaugurated. To facilitate the refinancing of the large national debt, MOF issued Y500 billion ($2.9 billion) worth of short-term bonds during fiscal 1985 in minimum denominations of Y100 million ($588,000). Initially, securities companies were not allowed to participate in short-term bond trading.

Several other changes went into effect at the same time:

- The minimum denomination of certificates of deposit and money market certificates was reduced to Y100 million ($588,000) and Y50 million ($294,000), respectively.

- Foreign subsidiaries or branches of Japanese companies were allowed to issue Euroyen instruments with maturities longer than one year. The minimum credit rating necessary for Euroyen issuers was also reduced from AA to A.

- Effective June 1, under new guidelines for overseas banking, off-balance-sheet items had to be reported; foreign liabilities were limited to 14 times shareholders' equity; limits were set on high-risk loans; the loan growth ceiling was raised to 20 percent annually; the ceiling on lending or borrowing in foreign currencies was eliminated; limits on the amount of loans to a single country were raised or eliminated; and participation in international loan syndicates was liberalized. On the same day:

- A bankers' acceptances market was established to facilitate trade finance and improve bank liquidity. First-day trading in short-term trade bills totaled a respectable Y72.1 billion ($424 million).

- An additional 50 banks were authorized to trade in outstanding government bonds, bringing the total to 87; bonds of all maturities were tradable for the first time.

- Securities houses were authorized to trade certificates of deposit, joining the 13 banks given permission in March.

- Effective September 10, the Bank of Japan liberalized interest rates paid on time deposits of Y1 billion ($5.9 million) or greater with terms of three months of more. This was the initial step in MOF's plan to liberalize deposit rates.

- Effective October 15, a bond futures market was inaugurated to help smooth the refinancing of the deficit and assist the transition to the heavier use of short-term bonds. After some initial success, the market, made up mainly of large banks, was devastated by the BOJ's interest rate cuts.

Other actions also opened Japan's financial markets to international influence. In July MOF announced that it would admit eight foreign banks to Japan's trust banking market, removing a source of friction with its trading partners. In September the Tokyo Stock Exchange voted to increase its associate membership by 10 seats and give associate members the same rights as full members in critical areas. As a result, Merrill Lynch & Co. and Morgan Stanley & Co. won associate memberships along with four other foreign brokers, eliminating another sore point. Tokyo's July 30 market liberalization "action program" also included commitments and timetables to deregulate several other areas (see JEI Report No. 31B, August 16, 1985).

All this activity had an unsurprising effect on Japan's long-term capital payments balance. A record deficit of $64.5 billion accumulated in 1985, continuing the huge net outflows begun in 1984 (see JEI Report No. 5B, February 7, 1986). A great deal of the capital came to this country, helping to finance the U.S. government's tremendous borrowing needs. In effect, the two financial systems have become increasingly interdependent, posing problems for the conduct of monetary policy.

Indirectly, therefore, the yen-dollar exchange rate was also heavily influenced by MOF's financial liberalization drive. As measured by the daily median rate on the Tokyo interbank spot market, the yen averaged Y254.18=$1.00 in January 1985. After falling slightly to Y260.24 in February, the yen began a steady upward drive against the greenback. In September, when the finance ministers of the United States, United Kingdom, West Germany, France and Japan met, the yen had already gained 6.8 percent against the dollar and stood at Y236.95. When the Group of Five agreed to lead the dollar lower against the yen and the West German mark, markets reacted strongly. The dollar bought an average of just Y202.83 in December, a 20.2 percent drop from the beginning of the year. It appeared that the yen internationalization/market deregulation program was beginning to pay off. The yen seemed to more truly reflect the relative strength of the Japanese economy, but the rapid appreciation began to worry Japanese officials.

Fiscal Policy

In a continuing effort to balance the budget, the government clamped the same tight lid on discretionary spending in FY 1985 as in the three previous fiscal years. A strict policy prevailed despite intense debate over the wisdom of austerity. Not only was the prime minister pressured by Diet members whose districts rely heavily on government spending, but he was also attacked by party rivals seeking to position themselves for the premiership. Kiichi Miyazawa, a dark horse in the race, proposed an ambitious "asset doubling" plan modeled after the highly successful "income doubling" drive of the 1960s. Mr. Miyazawa called for greatly expanded government spending on social infrastructure, such as parks, sewers, housing and roads, to bring Japan's standard of living up to the level of its Western counterparts. Mr. Nakasone, on the other hand, had made fiscal reconstruction one of the hallmarks of his administration and refused to back down. The fiscal 1985 budget clearly bore his imprimatur.

The 3.7 percent rise in FY 1985 overall general account outlays gives a false impression of growth, since it was due to an 11.7 percent increase in debt service costs and a 9 percent rise in transfers to local governments, both mandatory outlays. Discretionary spending was actually cut by Y263.2 billion ($1.5 billion), as the budget ax fell on pensions (-1.2 percent), public works (-2.3 percent), small business measures (-5.7 percent), and agricultural price supports (-14.5 percent). On the other hand, the prime minister continued to expand areas of interest, including social security (2.7 percent), education and science (0.2 percent), defense (6.9 percent), economic cooperation (7.8 percent) and energy measures (4.2 percent).

Business bore the brunt of FY 1985's special taxation measures, as MOF reduced the deductible for bad debts and eliminated the deferral of taxes for companies experiencing operating losses (see JEI Report No. 20A, May 24, 1985).

Even government and non-profit corporations were hit by rising tax rates. At the same time, though, MOF instituted a tax credit for research and development costs and investment in state-of-the-art equipment. But the net overall effect was an increase in revenues of Y316 billion ($1.9 billion).

The Fiscal Investment and Loan program, a self-funding second budget, actually declined 1.2 percent in FY 1985. All programs except for water works, disaster prevention, roads and regional development were cut by up to 13.9 percent. This was the first time in postwar history that the FILP had been reduced, and reflected Mr. Nakasone's decision to cut back on all types of government borrowing, even that intended for specific public works projects.

The FY 1985 supplemental budget, approved in December, was also a modest Y723 billion ($4.3 billion). The supplement was devoted mainly to disaster relief, a pay hike for government employees and increased funding for the Housing and Urban Development Corp. The fact that the budget was significantly less than FY 1984's Y886 billion ($5.2 billion) level was another indication of just how hard spending was being squeezed.

Given this state of affairs, it was not surprising that the public sector failed to make a positive contribution to last year's GNP growth. As the yen began to rise rapidly during the last quarter of 1985, policymakers grew increasingly concerned that fiscal austerity would trigger an economic slowdown. Nevertheless, the prime minister and the Ministry of Finance have resisted a return to pork-barrel politics. Instead, they have sought to promote private investment activity in housing and other large construction projects. Critics contend that this scheme will have little impact, but they have been unable to provide convincing alternatives.

With the opposition confused, Mr. Nakasone was also able to push ahead with his administrative reform program. The privatization of Nippon Telegraph and Telephone Public Corp. and Japan Tobacco and Salt Public Corp. on April 1, 1985 led to a boom in the domestic telecommunications market and provided better access to Japan's market for foreign tobacco product makers. Although the impact on government accounts was minimal (since the government maintains control of both entities), the move will eventually make government smaller by removing these two organizations from government balance sheets. Mr. Nakasone also moved in earnest to privatize the last major public corporation, Japanese National Railways. Because of its large excess employment problems, however, JNR reform proved to be a very sensitive issue. Nevertheless, preliminary steps were taken to push JNR out of the government's nest by 1987.

Conclusion

Although Japan's economy performed well in 1985, problems that were hidden during 1984's recovery came to the surface. The nation's sensitivity to foreign trade was paralleled by a new sensitivity to international financial forces. Japan's trade surplus grew so large as to invite comparisons with the surplus accumulated by members of the Organization of Petroleum Exporting Countries in the 1970s. At the same time, however, Japan realized that it was necessary to actively recycle this surplus through financial markets to prevent an international liquidity crisis. This did not insulate Tokyo from the harsh criticism of its trading partners. Although Tokyo continued to stress non-fiscal means of stimulating the domestic economy, it did agree to cooperate in an effort to lower the dollar against the yen. The failure of the former and the success of the latter put the Japanese economy in an precarious position by the end of 1985.

For further information, contact Jon Choy.

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REPORT

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JDA To Produce Domestic Fighter?

A report in the June 6 edition of the Asahi Shimbun suggests that the Japan Defense Agency is leaning toward joint U.S.-Japanese development of a domestically produced aircraft for the FSX program, a new fighter support aircraft intended to replace outdated F-1s and F-4s. Only a few weeks ago, press reports in both countries said that JDA had abandoned hopes for a domestic fighter in favor of co-produced F-18 Hornets, both for political and economic reasons. The possibility had also been raised that an F-18 designed to Japanese specifications -- so-called Super Hornets -- was also in the running, but the latest report suggests that JDA has returned to the domestic option, this to consider it a conciliatory gesture in that it implicitly suggests that the disputed islands are not in fact part of the Soviet Union.

However, Soviet leader Mikhail Gorbachev made it clear during the Abe visit that the Soviet Union has not altered its view that no issue exists over the northern territories despite Japanese claims to the contrary. Some observers have claimed that this hard line is simply a Soviet ploy to "save face" or maintain negotiating leverage in peace treaty talks. Optimists feel that there is room for an agreement, since Soviet officials keep talking about an issue, although officially they claim there is no issue. At the very least, the current round sustains the momentum established in 1985 toward improved relations -- an important goal for both governments -- and allows both sides to claim victory while seeking further concessions.

Michael W. Chinworth

Falling Oil Prices Affect Japanese Exports To The Middle East

During the first three months of 1986, Japan's imports of oil (crude and partly refined) declined 34 percent in yen terms from the same quarter a year ago, reflecting a drop in both volume and unit price. Volume declined 2.6 percent to 52.5 million kiloliters, while the price dropped to Y31,245 ($184 at Y170=$1.00) per kiloliter, down from Y46,297 ($272) a year earlier. In dollar terms, oil imports fell 12.2 percent to $8.5 billion.

The skid continued in April as oil deliveries fell 20 percent from the same month last year, reaching the third lowest monthly volume in recent years. In addition, there was a noticeable decline in oil purchased from members of the Organization of Petroleum Exporting Countries, whose share of imports fell to 69.8 percent, down from 75.4 percent in March. Shipments from Malaysia and Mexico expanded 24.1 percent and 75.8 percent, respectively, while imports from the United Arab Emirates fell 24.5 percent and Saudi Arabian shipments dropped 53.4 percent. The latter two countries, however, still accounted for almost one-third of Japan's oil imports.

Declining oil prices and the strong yen have contributed to the continued slump in Japanese exports to the Middle East. Shipments, which plummeted from $17.2 billion in 1983 to $12.2 billion in 1985, declined another 4.8 percent in the first quarter of 1986 compared to the year-earlier period (see Table). As a result, the share of Japanese exports going to the Middle East declined from 11.7 percent in 1983 to 5.9 percent. This helped increase Japan's dependence on the U.S. market, which accounted for 36.8 percent of Japanese exports in the first quarter of 1986, up from 29.2 percent in 1983.

Fourteen Middle East countries, including the UAE, Saudi Arabia and Iraq, either peg or closely link their currencies to the U.S. dollar. With its sharp rise against the dollar, the yen has also appreciated against most Middle Eastern currencies. Sales of Japanese cars, for example, normally the market leader in the UAE, dropped 15 to 25 percent during the first four months of 1986. The currency of the UAE, the leading exporter of oil to Japan, has lost one-third of its value against the yen since last September.

Ironically, in light of the controversy in Japan over the summit declaration against terrorism, Libya is a relatively minor trading partner. Japan's exports to Libya fell 39 percent in 1985 to only $253 million, and declined further in the first three months of 1986. Imports of oil from Libya have tapered off sharply since the early 1980s. The low sulphur content of Libyan oil makes it a popular commodity in Europe, but Japan favors less expensive oil from other nations.

Japan's Trade With Middle East Countries

(in millions of dollars)

	January-March 1985		January-March 1986	
Country	Exports	Imports	Exports	Imports
United Arab Emirates	$250	$2,239	$255	$2,532
Saudi Arabia	954	3,387	740	1,956
Iran	282	827	283	751
Iraq	194	88	399	432
Kuwait	379	311	330	500
Oman	157	690	97	605
Qatar	46	477	46	525
Egypt	168	137	164	96
Libya	80	7	61	7
Total*	2,824	8,337	2,689	7,604

*Includes Bahrain, North and South Yemen, Israel, Jordan, Syria, Lebanon, Gaza, Cyprus, Sudan, Ethiopia, Republic of Djibouti and Somalia.

Source: Japan Tariff Association

Randall S. Jones

Services Trade Spurs Emotional Testimony

At the moment, there is little coherence or coordination in the Senate's approach to trade issues. While members of both parties continue to give assurances that there will be a trade bill this year, tax reform fills the hours of the most crucial players -- the members of the Finance Committee. Despite the dramatic passage of the trade reform bill in the House of Representatives, momentum in the Senate has been slow to develop.

Anxious Hill watchers had something to mull over when Sen. Frank Murkowski (R, Alaska) reconvened his series of hearings on U.S.-Japan services trade (see JEI No. 31B, August 14, 1985). Previous sessions focused on trade in transportation services; the June 5 meeting concentrated on construction, engineering and financial services. Particular attention centered on U.S. participation in Japanese public works projects, specifically the planning and construction of the $8 billion Kansai International Airport near Osaka.

high-cube service from the point of departure. In an effort to match this, Japanese firms are purchasing the bigger boxes and upgrading facilities on some routes. In addition, they are seeking links with U.S. railroad companies to provide smooth ship-to-rail service. Although most Japanese shippers consider the adoption of high cubes for domestic use inevitable, they expect the process to take several years as numerous bureaucratic and infrastructural barriers must be overcome.

The convergence of these two factors -- a tougher U.S. stance and pressure from domestic companies -- will undoubtedly encourage Tokyo to loosen high-cube controls at a quicker pace. That pace, however, may not be fast enough for Washington, particularly if Congress focuses more attention on the issue. The Reagan administration may feel pressed enough to include the topic in the new round of market-oriented sector-selective (MOSS) talks.

Jon Choy

The U.S. Trade Deficit: No Light Yet At End Of Tunnel

In the eight months since Washington orchestrated the decline in the dollar's value, Reagan administration economic policymakers and business economists alike have repeatedly tried to dampen expectations of a quick turnaround in the U.S. trade deficit, which ballooned to $148.5 billion (imports c.i.f.) last year. Progress will be painfully slow, they caution, adding that the numbers will get worse before they get better. No one expects the final 1986 red-ink entry to be as huge as the $174 billion indicated by a straight-line projection of the trade gap in the January-March period. But neither do analysts anticipate any improvement in the quarterly figures until mid-year at the earliest.

A look at U.S. trade with Japan in 1986's first quarter highlights why the dollar's fall will not show up any time soon in the overall trade results. On paper the 40 percent-plus drop in the dollar against the yen since late last September has restored the competitive position of American exporters to the pre-1980 level, but in practice the faltering pace of the Japanese economy has neutralized this advantage. Exports, in fact, were off 10.9 percent in the first three months of the year to $5.6 billion as the slower growth of Japanese industrial production trimmed shipments of intermediate inputs and scaled-back investment plans translated into smaller exports of capital goods.

At the same time, the flip-flop in the dollar-yen relationship has not yet proved to be the marketing handicap for Japanese manufacturers that textbooks suggest, simply because big exporters have opted to sacrifice short-term profit margins on U.S. sales to maintain market share. Imports from Japan therefore jumped another 20.2 percent in the January-March 1986 period to $20.9 billion (c.i.f.) on generally higher volume. In the process, the bilateral trade gap, which had climbed to $49.8 billion last year, swelled to $15.3 billion or, simple arithmetic indicates, $60 billion-plus at an annual rate.

Trends in first-quarter trade with Japan, it turns out, merely magnified what was happening elsewhere in the U.S. trade picture. Total exports fell

U.S. Exports to Japan

(in millions of dollars, f.a.s. value basis)

	January-March 1985	January-March 1986	Percent Change
Total Exports	$6,252.3	$5,573.6	-10.9%
Industrial Supplies	2,434.5	2,090.6	-14.1
Bituminous Coal	231.2	158.3	-31.5
Petroleum Products	217.5	189.2	-13.0
Natural Gas	72.4	42.0	-42.0
Nuclear Fuels	42.7	0.1	-99.8
Logs and Lumber	215.2	235.4	9.4
Paper Base Stocks	123.8	118.4	-4.4
Paper and Paper Products	67.6	79.0	16.9
Organic Chemicals	183.2	190.8	4.1
Inorganic Chemicals	256.8	200.9	-21.8
Plastics and Synthetic Resin Compounds	80.1	77.2	-3.6
Fertilizers and Insecticides	90.8	91.7	1.0
Steel Scrap	52.5	63.1	20.2
Nonferrous Ores and Scrap	110.1	134.9	22.5
Nonferrous Metals	91.3	61.7	-32.4
Textiles	31.3	27.0	-13.7
Raw Cotton	183.9	54.3	-70.5
Hides and Skins	69.8	87.3	25.1
Leaf Tobacco	40.0	23.6	-41.0
Capital Goods	1,736.3	1,476.2	-15.0
Nonelectric Machinery	932.7	844.6	-9.4
Data Processing Equipment and Parts	370.4	335.4	-9.4
Measuring, Testing and Control Instruments	136.3	105.5	-22.6
Laboratory Testing and Control Instruments	31.0	28.6	-7.7
Scientific, Professional and Medical Equipment	69.8	77.7	11.3
Oil and Gas Field Equipment	9.3	23.9	157.0
Metalworking Equipment	29.7	39.0	31.3
Service Industry Equipment	30.6	31.8	3.9
Electric Machinery	236.5	224.4	-5.1
Generators and Transformers	20.4	19.2	-5.9
Broadcast and Communications Equipment	102.1	88.7	-13.1
Telephonic and Other Electric Equipment	114.0	116.5	2.2
Transportation Equipment	567.1	407.2	-28.2
Civilian Aircraft	355.8	159.7	-55.1
Civilian Aircraft Engines and Parts	138.4	164.1	18.6
Automotive Parts	44.1	53.5	21.3
Food and Feed	1,213.7	1,238.8	2.1
Corn	371.8	303.0	-18.5
Sorghum	105.4	77.0	-26.9
Soybeans	246.5	248.7	0.9
Wheat	118.1	109.5	-7.3

Fruits and Vegetables	103.8	126.5	21.9
Meat and Meat Products	130.0	172.0	32.2
Fish and Fish Products	52.7	92.1	74.8
Consumer Goods	368.4	385.4	4.6
Pharmaceuticals	155.2	167.5	7.9
Toys and Sporting Goods	23.2	20.5	-11.6
Cigarettes	21.5	26.2	21.9

U.S. Imports from Japan

(in millions of dollars, Customs value basis)

	January-March 1985	January-March 1986	Percent Change
Total Imports	$16,493.4	$19,947.6	20.9%
Automotive Products	5,380.5	7,370.7	37.0
Passenger Cars	3,326.6	4,415.2	32.7
Trucks	983.6	1,463.8	48.8
Automotive Parts	1,068.7	1,486.2	39.1
Capital Goods	5,529.2	6,381.3	15.4
Nonelectric Machinery	3,750.8	4,364.1	16.4
Business Machines	1,748.4	1,990.3	13.8
Metalworking Machinery	292.1	334.4	14.5
Agricultural Machinery	101.5	146.5	44.3
Specialized Industrial Machinery	313.4	370.3	18.2
Scientific, Professional and Medical Equipment	147.7	215.0	45.6
Electric Machinery	1,710.1	1,878.6	9.9
Transportation Equipment	68.3	138.6	102.9
Consumer Goods	3,449.4	3,970.5	15.1
Video and Audio Recorders and Players and Stereo Equipment	1,302.7	1,452.0	11.5
Television Sets	190.8	228.7	19.9
Radio Receivers	82.3	63.1	-23.3
Tableware and Glassware	109.4	119.4	9.1
Metal Cookware and Cutlery	98.0	123.7	26.2
Photographic and Optical Goods	242.8	280.5	15.5
Clocks and Watches	114.6	108.8	-5.1
Toys and Sporting Goods	118.3	130.0	9.9
Motorcycles and Parts	224.1	342.4	52.8
Clothing	132.1	138.3	4.7
Intermediate Goods	1,865.8	1,929.2	3.4
Steel Mill Products	867.6	740.5	-14.6
Nonferrous Metals	126.2	138.2	9.5
Organic Chemicals	151.0	177.9	17.8
Textiles	174.0	223.7	28.6

4.4 percent to $53.7 billion, clipped not only by sluggish growth in Europe and Canada as well as in Japan but also by the continuing debt problems of the Third World and the ongoing decline in revenues earned by oil-exporting countries. On the other side of the ledger, aggregate imports advanced 11 percent to $97.1 billion, in large part because the dollar has held steady or even appreciated against the currencies of five of this country's top ten suppliers -- Canada, which alone accounts for roughly one-fifth of all imports, Mexico, Taiwan, Korea and Hong Kong.

Susan MacKnight

Notes

- On June 4 the Department of Commerce adopted a rule change that would allow the state of Alaska to export crude oil to Japan. The change in the Export Administration Regulations, earlier pledged by President Reagan, allows crude produced from the "state-owned submerged lands" of the Cook Inlet oil fields to be shipped overseas. Since this oil does not pass through or over any federal rights-of-way or pipelines, no amendment to the Export Administration Act, Energy Policy and Conservation Act, or Mineral Lands Leasing Act is necessary. Alaskan officials estimate that production of Cook Inlet wells will average 40,000 barrels a day in 1986, although this is expected to decline by 15 percent per year. Without further development of the inlet's resources, the Commerce Department estimates that no more than 20,000 barrels per day of private petroleum and 4,000 to 5,000 barrels per day of state royalty crude will be available for export.

Tokyo has long been interested in purchasing Alaskan oil but has been blocked by U.S. laws aimed at promoting energy self-sufficiency. The governor of Alaska has also supported sales of crude to Japan as a way to bolster state revenues but has been unable to generate enough interest in Congress to amend the laws. U.S. oil shipping interests have opposed the change, fearing reduced traffic to West and Gulf Coast refineries, and alarmed that the freight business would go to Japanese carriers. Commerce adopted the exemption for Cook Inlet oil partly on the grounds that the quantity was too small to have an impact on American cargo companies. It remains to be seen, however, if Japan will actually sign delivery contracts. With global markets still awash in oil, Japan may not feel pressed to buy the newly freed oil.

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Politicians Play The Numbers Game

Japanese politicians have begun to take their positions in advance of the July 6 lower and upper house elections, carefully balancing party and personal interests to assure maximum bargaining strength in the factional jockeying expected to follow the balloting for president of the Liberal Democratic Party and prime minister.

Prime Minister Yasuhiro Nakasone has issued his targets for the campaign: slightly more than simple majorities in both houses. For the lower house -- the more important of the two -- this translates into 257 seats, seven more than the party presently holds. (The Liberal Democrats have been able to hold on to power in the 511-seat lower house through a coalition with the New Liberal Club, which has eight members in the chamber.) Mr. Nakasone's strategy

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While generally approving, the Ministry of Finance expressed concern over the report's statement that the government "may possibly take temporary, emergency measures" to cope with abrupt changes in the economic situation. The MOF is worried that this may encourage support for a massive supplementary budget in the fall to stimulate the domestic economy. At a June 9 strategy session for next month's election, leaders of the ruling Liberal Democratic Party proposed a Y3 trillion ($17.6 billion at Y170=$1.00) supplementary budget.

The study summarized the administrative and fiscal reform measures taken over the past five years. The council was established in 1983 to follow up the work of its predecessor, the Ad Hoc Council on Administrative Reform, organized in 1981, and will be disbanded at the end of the month. Both committees were chaired by Toshiwo Doko, former chairman of Keidanren. The report proposed the creation of a watchdog commission aimed at ensuring further progress in administrative reform, an idea publicly favored by the prime minister.

Mr. Nakasone told the council that the basic themes of the report -- the need for smaller government and better utilization of private resources -- constitute the foundation of government policy. In addition to fiscal reconstruction, major initiatives pushed by the council during the past five years include the privatization of Nippon Telegraph and Telephone Corp., Japan Tobacco and Salt Corp. and Japanese National Railways.

To ensure economic vitality the council called on the government to refrain from raising taxes. Tax payments and social security costs absorb 35 percent of income in Japan, the report noted, compared to around 50 percent in Europe. Next year's tax reform, the council believes, should focus on improving the fairness of the tax system rather than raising taxes. Other ideas contained in the report include adjusting the allocation of costs and responsibilities between national and local governments, centralization of autonomous city and rural governments, and an easing of government controls on semi-public corporations.

Randall S. Jones

"Yen's Rise Brings No Fall In Import Prices," Complains Nakasone

Domestic and international political considerations have goaded Prime Minister Yasuhiro Nakasone to direct the cabinet to find ways of translating the stronger yen into lower retail prices for imported goods. Although the utility companies have agreed to pass on to the consumer a significant share of the windfall profits resulting from a stronger yen and lower oil prices, the impact of appreciation on department- and grocery-store items has been minimal.

From Japan's point of view, the yen has increased in value by almost 50 percent against the dollar in 12 months. This would seem to imply a price cut on imports of up to one-half. According to a Ministry of International Trade and Industry survey of 20 imported items, half showed no or smaller declines at the retail level than at dockside, and the other half showed equal or greater cuts (see Table). Ministry officials blamed Japan's intricate web of distributors and middlemen for the disparate price results.

Changes in Import and Retail Prices

(in yen and percentage change)

		Retail Price			
				Change	
Item	Import Price Change	August 1985	March 1986	Yen	Percent
Socks, Class A	Y-35	Y300	Y289	Y-11	-3.7%
Class B	0	250	200	-50	-20.0
Underwear	-23	650	650	0	0.0
Shirts and blouses, Class A	-170	2,040	1,480	-560	-27.5
Class B	-190	2,915	2,915	0	0.0
Jeans	-320	6,700	6,700	0	0.0
Neckties, Class A	-80	13,500	13,500	0	0.0
Class B	-750	15,000	15,000	0	0.0
Class C	90	15,000	15,000	0	0.0
Handbags, Class A	-250	2,480	2,480	0	0.0
Class B	-590	43,000	43,000	0	0.0
Athletic shoes, Class A	-340	5,800	5,300	-500	-8.6
Class B	-150	2,500	2,000	-500	-20.0
Class C	-150	1,980	1,980	0	0.0
Class D	-500	12,500	12,500	0	0.0
Umbrellas	-60	798	638	-160	-20.0
Wrist watches, Class A	-420	3,980	2,980	-1,000	-25.1
Class B	0	68,000	68,000	0	0.0
Class C	-1,720	224,000	224,000	0	0.0
Electric razors	(-3.2%)	12,850	12,850	0	0.0
Golf clubs, Class A	-1,850	112,000	98,000	-14,000	-12.5
Class B	-3,220	150,000	98,000	-52,000	-34.7
Class C	-8,670	160,000	128,000	-32,000	-20.0
Tennis rackets	-1,710	23,450	20,880	-2,570	-11.0
Athletic balls, Class A	-14	660	660	0	0.0
Class B	-230	6,000	2,900	-100	-3.3
Class C	-230	6,480	6,480	0	0.0
Passenger cars, Class A	-337,000	5,600,000	5,150,000	450,000	-8.0
Class B	-30,000	3,950,000	3,950,000	0	0.0
Tires	0	11,000	11,000	0	0.0
Ballpoint pens, Class A	-120	2,000	2,000	0	0.0
Class B	0	10,000	10,000	0	0.0
Class C	-435	60,000	60,000	0	0.0
Photographic film	0	560	560	0	0.0
Home aluminum goods, Class A	-180	2,280	1,980	-300	-13.2
Class B	-340	1,980	1,380	-600	-30.3
Records	-200	2,210	2,032	-175	-7.9

Source: Ministry of International Trade and Industry

At a June 16 cabinet meeting, Mr. Nakasone targeted imported clothing, alcoholic beverages and food products as good prospects for price cuts. He urged his ministers to insure that at least all government-influenced companies pass on exchange rate profits. Japan Air Lines Co., Ltd., for example, should let its prices for imported whiskey served to passengers reflect the stronger yen, he said. His reasons for this unusual stand are clear: Japan's trading partners are growing increasingly anxious as the trade surplus continues to expand. In addition, the double Diet elections are rapidly approaching. Lower retail prices on imports should improve the Liberal Democratic Party's image with the voters and help deflect foreign criticism about Japan's sluggish imports.

It is unlikely that the prime minister's exhortations will have a significant or rapid effect. Just as U.S. distributors of Japanese products pocketed part of the gain when the yen was weak, Japanese importers can hardly be expected to deny themselves the benefit of a weak dollar. Even if each distributor took just a small share of the windfall profits, the impact at the retail level might still be small since there are many more marketing layers in Japan than in the United States. Since it is unlikely that the government will take action to drastically alter the inefficient distribution system, Japanese consumers will probably receive only a few drops of the "trickle down" effect of lower import prices.

Jon Choy

Japan-EC Talks Focus On Damage Control

Japanese and European Community officials met June 10-12 in Geneva to discuss current bilateral issues, with trade developments topping the list. Once again, both sides reiterated their commitment to enhancing scientific cooperation and promoting Japanese direct investment on the continent. With these appetizers out of the way, negotiators sat down to the main course of trade relations.

Europe and Japan continue to find common ground in discussions of the peaceful uses of nuclear energy. Previous agreements have encompassed the development of new reactors and fuel reprocessing techniques. In the aftermath of the Soviet nuclear accident at Chernobyl, officials agreed to increase safety information exchanges and cooperate on efforts to improve international nuclear safety standards.

Japan also sought to strengthen the environment for direct investment in European production facilities. Although an increasing number of Japanese firms were already interested in overseas production, the yen's rapid appreciation against European currencies has made that option even more attractive. Moreover, the Community has been more aggressive in imposing dumping penalties on a wider range of Japanese exports, adding to the momentum for direct investment.

While both sides agree that the stronger yen should cut into the bilateral trade imbalance, Japan's surplus with the EC continued to expand during the first three months of the year, rising from just under $1 billion in January to a record $1.6 billion in March. While the gap fell slightly to $1.4

Table 1: Japan's Trade with the European Community, January-April 1986

(in millions of dollars and percentage change over 1985)

a. Exports (f.o.b.)

	January		February		March		April	
EC	$1,883.2	37.2%	$2,289.9	52.9%	$2,616.6	52.6%	$2,564.6	74.8%
Great Britain	456.1	28.2	493.3	49.6	554.7	37.3	545.5	65.7
Netherlands	198.6	87.6	225.3	55.6	262.2	61.8	266.7	70.0
Belgium	131.7	69.8	175.8	69.2	199.3	71.4	205.6	98.4
France	198.2	53.5	241.4	59.2	295.4	75.0	261.5	52.2
West Germany	611.5	44.7	796.2	54.0	881.9	55.4	892.4	77.0
Italy	98.2	48.5	135.1	49.0	154.1	59.2	134.9	48.3
Spain	45.9	51.0	76.0	73.1	99.2	100.4	87.3	83.7
Greece	53.0	55.7	27.1	-42.2	26.1	-80.7	42.1	-2.2

b. Imports (c.i.f.)

	January		February		March		April	
EC	$884.3	30.7%	$831.8	25.6%	$1,008.5	40.9%	$1,159.7	63.9%
Great Britain	152.6	6.4	176.8	29.8	192.8	35.5	327.4	116.9
Netherlands	40.3	7.4	35.8	11.1	52.4	43.6	42.8	27.6
Belgium	33.4	7.2	43.4	-14.6	51.6	18.5	65.5	63.0
France	113.0	42.6	121.3	-1.2	139.4	26.3	144.3	44.1
West Germany	330.3	46.4	252.1	35.3	326.7	53.7	372.2	53.1
Italy	93.7	35.1	101.3	24.2	113.7	34.4	91.4	11.9
Spain	35.0	20.7	19.6	16.2	41.0	80.0	17.1	-76.6
Greece	2.8	-20.8	16.3	1,545.4	5.5	-88.1	2.2	43.7

Source: Japan Tariff Association

Table 2: Japanese Exports to the EC by Product, April 1986

(in millions of dollars and percentage change over 1985)

	EC	Great Britain	Netherlands	France	West Germany	Italy	Greece
Total	$2,564.6	$545.5	$266.7	$261.5	$892.4	$134.9	$42.1
	74.8%	65.6%	70.3%	52.0%	77.0%	48.3%	-2.2%
Food	10.3	2.3	1.1	3.9	1.3	0.3	0.1
	103.1%	17.2%	6.6%	426.6%	213.0%	12.0%	576.0%
Textiles and Clothing	60.8	19.1	3.5	10.0	17.8	4.4	0.3
	92.7%	53.7%	114.6%	131.7%	114.2%	76.5%	43.4%
Chemicals	112.4	14.2	15.1	16.0	31.7	14.6	0.5
	40.2%	39.2%	7.6%	44.1%	26.0%	52.8%	104.5%
Nonmetallic Mineral Manufactures	18.0	4.2	1.5	2.3	5.0	2.1	0.2
	71.7%	56.0%	116.7%	46.3%	73.9%	143.4%	-19.6%
Metals and Metal Products	57.5	10.4	6.5	5.3	19.6	4.5	1.0
	17.3%	-13.4%	-16.8%	-50.7%	66.5%	79.8%	-41.3%
Machinery and Transport Equipment	2,065.1	446.3	212.0	194.0	732.9	95.5	34.0
	79.4%	69.2%	84.3%	54.3%	80.1%	45.7%	-13.2%
Office Equipment	240.3	52.1	19.5	19.6	103.7	17.3	0.3
	79.9%	96.7%	51.0%	43.0%	72.3%	68.0%	-3.7%
Metalworking Machinery	45.1	5.7	1.5	4.1	19.0	0.9	0.0
	117.6%	33.0%	8.5%	56.7%	160.3%	69.0%	-86.1%
Radios	56.1	16.2	2.7	3.9	19.7	0.2	0.5
	71.5%	85.9%	33.5%	156.3%	44.3%	115.2%	-8.7%
Semiconductors and Electronic Tubes	103.5	20.8	2.7	6.6	56.0	6.5	0.1
	47.8%	21.8%	5.3%	27.8%	60.4%	74.5%	330.8%
Motor Vehicles	469.7	115.0	57.6	26.7	162.4	1.0	8.5
	159.1%	165.3%	172.5%	58.6%	215.8%	-56.0%	12.6%
Precision Equipment	224.8	35.4	35.2	19.4	100.9	9.9	0.5
	58.2%	32.2%	68.3%	4.9%	72.3%	28.1%	137.6%
Other	240.6	49.0	26.5	30.0	84.1	13.6	6.0
	72.1%	85.8%	64.5%	20.0%	73.2%	38.7%	292.9%

Source: Japan Tariff Association

billion in April, May's $1.5 billion mark is cause for concern in Tokyo. The trade boom is even more apparent when recent statistics are compared with year-earlier levels (see Table 1). Economic activity in Europe is clearly on the upswing, increasing the demand for imports. Of particular concern to both sides, however, is the rapid rise in Japanese shipments of particular items, including automobiles, electronic parts and precision equipment (see Table 2).

Japanese manufacturers are already restraining EC-bound exports of several items, including televisions and video cassette recorders, while a dozen other products are under EC surveillance. In addition, five EC nations impose limits on imports of Japanese cars. As might be expected, the surge in exports is confined to those countries that do not impose trade restraints. Precision equipment exports to West Germany, for example, jumped 72.3 percent in April over the previous year, while deliveries of the same category to France rose only 4.9 percent.

The big leaps can be partly attributed to the immediate impact of the stronger yen on dollar-based trade figures. A rate of Y178.70=$1.00 was used to calculate April 1986 figures while Y254.35=$1.00 was used for the same month in 1985, a 42.2 percent change.

In an effort to pre-empt further protectionist moves by the EC, the Ministry of International Trade and Industry is reportedly considering asking auto makers to slow the rate of growth of shipments to Europe. It is not clear if MITI will seek a fixed rate of growth or intends to be more flexible. MITI's decision will certainly be based on EC reactions and comments.

Jon Choy

U.S.-Japan Air Services To Expand

Trans-Pacific air travelers will soon have more choices of carriers and routes between Japan and the United States. Beginning July 2 Japan Air Lines will offer nonstop flights from Tokyo to Atlanta, making two round trips a week in the first regular service between Japan and the Southeast. Two weeks later All Nippon Airways will inaugurate scheduled service to this country with the start of five weekly nonstop round trips between Tokyo and Los Angeles. Then on July 26 Japan's major domestic carrier will start flying the Tokyo-Washington route three times a week -- the first direct air link between the two capitals. This fall, moreover, Delta Air Lines expects to launch trans-Pacific service, operating five weekly round-trip flights from Atlanta to Tokyo via Portland, Oregon. It will be joined next spring by American Airlines, another new competitor in the U.S.-Japan market. On May 1, 1987 the number-two U.S. carrier plans to offer nonstop service five times a week between Dallas/Ft. Worth, the first gateway in the Southwest, and Tokyo.

The first expansion in U.S.-Japan air services since United Airlines began flying between Seattle/Portland and Tokyo in April 1983 and JAL simultaneously started operating on the Tokyo-Seattle and Tokyo-Chicago routes was worked out in the spring of 1985 (see JEI Report No. 18B, May 10, 1985). That interim arrangement allowed each country to offer up to three new passenger-cargo services effective April 1 of this year. These services had to be

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U.S. EXPORTS TO JAPAN: A REVIEW OF 1985 SALES

Summary

After increasing during the first two years of the current Japanese economic expansion, U.S. exports to Japan stumbled in 1985, falling 4 percent to $22.6 billion. While sales were expected to be off, the size of the drop was somewhat surprising since domestic demand generated more of Japan's growth last year than in either 1983 or 1984 and the dollar peaked against the yen in February 1985 after a two-year run-up in value. One key to the riddle was lower international commodity prices; another was stiffer competition for sales of industrial and agricultural inputs. These developments in fact accounted for a big part of the drop in exports of intermediate goods, which were down 5 percent to $8.7 billion, and virtually all of the 15.7 percent contraction to $5 billion in sales of food and feed. At the same time, sales of capital goods, the category most affected by the performance of domestic demand and the dollar-yen relationship, did expand, increasing 5.5 percent to $5.9 billion.

Export Profiles

Industrial Supplies - The first half of the 1980s was a difficult, frequently frustrating period for American suppliers of most big-ticket industrial raw materials and intermediate inputs -- ironically enough, for reasons that had nothing to do with the strong dollar. After two years of false starts, Japanese manufacturing output finally recovered in 1983, but the rebound generated little new export business for U.S. companies since it largely bypassed the basic industries that are the major consumers of imported industrial supplies. Neither did struggling exporters get much relief the next year when the expansion spread to this part of the manufacturing sector. A number of Japanese industries producing intermediates emerged from the recession leaner and more competitive, wiping out market opportunities for their American counterparts; in other industries, raw material exporters had to contend with third-country suppliers new to the Japanese market or intensified sales competition from old rivals. Already hard-pressed, U.S. exporters were dealt another setback in 1985: growth in Japan's basic industries slowed or even reversed course.

U.S. coal suppliers certainly faced a no-win situation last year. For starters, Japanese steel production, which had rallied in 1984 from a four-year slide, was flat, held down both by smaller orders from all major domestic steel users except automotive makers and by reduced shipments to every important export market other than China. Putting a double damper on coking coal demand, electric furnace operators again expanded output at the expense of integrated manufacturers. But these developments were the least of American exporters' troubles. The real problem was depressingly familiar: steel mills were overcommitted on coking coal deliveries from mines in Australia and Canada, a number of which are financed or owned in part by Japanese interests. To make room for these shipments, the mills resorted to the old standby of cutting purchases from U.S. coal companies. American producers consequently ended up supplying just 18 percent of Japan's 1985 coking coal imports -- half their 1982 market share and four points below the 1984 level. The fact that Japanese electric utilities bought more steam coal from this country did nothing to contain the U.S. industry's growing trade frustrations, which were exacerbated by the news that steel mills had increased coking coal imports from the Soviet Union and maintained deliveries from China and South Africa at 1984 volumes. In any case, the increase in steam coal shipments was too small to prevent total U.S. coal exports from dropping 11.1 percent to under $0.8 billion.

The contraction in coal shipments was an admittedly extreme example of the fallout from expanded import competition in the often sluggish Japanese market for industrial supplies, but the same script was acted out on a more modest scale for a number of other U.S. exports. Log and lumber suppliers can vouch for that. Japanese housing starts increased in 1985 for the second consecutive year, reaching their highest level since 1980, but this gain generated little extra business for sawmills, whether domestic or foreign, because of the long-term trend toward proportionately fewer wooden housing units and smaller average floor space. But Pacific Northwest log exporters got an unexpected break. In a complete reversal of 1984's picture, Japanese wholesalers and sawmills entered last year with skimpy stocks of North American softwood logs. To keep supplies from moving any closer to the level at which domestic prices come under pressure, importers build up inventory. Restocking gave U.S. producers the chance to make up the ground they had lost in 1984 when importers ran down inventories by limiting purchases from this country. But regaining this ground was an uphill battle since Canadian exporters were back in the market and again undercutting U.S. prices. Although the Canadian strategy yielded the same dividend as in 1984 -- deeper inroads in the Japanese imported softwood log market, U.S. perseverance also paid off: American exporters recaptured their 1983 market share, largely by taking sales from the Soviet Union,

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the number-two supplier. In the process, U.S. sales of logs and lumber went up 5.3 percent to just short of $0.9 billion.

A temporarily resurgent domestic industry and an expanded group of international rivals gave U.S. exporters of petrochemical intermediates a double taste of competition in 1985's slower-growing or flat Japanese market for plastics, synthetic fibers, surfactants, synthetic rubber, fertilizers and other downstream products. Japanese manufacturers of ethylene, the basic building block for petrochemical intermediates, got a better handle on their high production costs last year, thanks to continuing declines in the price of naphtha, the industry's predominant feedstock and fuel, and the completion of a government-orchestrated capacity-reduction program. Progress on the cost front did not erase the overall competitive edge of American suppliers of ethylene derivatives in the Japanese market, but it did limit or reduce export opportunities for specific commodity intermediates like acrylonitrile. In other commodity product markets, including ethylene dichloride, ethylene glycol and styrene, the sales fight had an added dimension: competition from newcomer Saudi Arabia and a more aggressive Canadian industry. Here the United States generally ended up being the odd man out.

The checkered export performance of petrochemicals was duplicated by the catch-all category of industrial inorganic chemicals. In general, these are also commodity products where international competitiveness is determined by plant size and/or supply availability -- both pluses for American makers; in some cases like soda ash and other chloralkalis, U.S. producers have an additional advantage over their Japanese competitors because of lower energy costs. But soft Japanese demand in a number of the diverse end-markets for commodity industrial inorganic chemicals -- automotive products, housing, paper and pulp, metals and fertilizers as well as other chemical products -- produced a mixed export record for U.S. companies. With flat sales of the biggest-ticket industrial inorganic chemical export -- uranium and thorium compounds, which are used primarily as catalysts and reagents in medical research and diagnostic procedures, total chemical sales slipped 1.5 percent in 1985 to $1.5 billion.

While increased competition from third-country suppliers made life difficult in 1985 for U.S. exporters of a long list of industrial inputs, West Coast petroleum refiners retained their role as swing suppliers of heavy (residual) fuel oil to Japan. Moreover, they continued to profit from the problems of the Japanese industry. Slower growth plus the ongoing switchover to nuclear power and liquefied natural gas for electricity generation and to coal for industrial fuel consumption forced Japanese oil refiners to reduce output again last year. This cutback, which dropped total fuel oil production to 75 percent of its 1980 level, left the country short on heavy fuel oil for specialized uses, including bunker fuel for coastal shipping. With U.S. consumption of gasoline and light (distillate) fuel oil up in 1985 but demand for heavy fuel oil off, California refiners had surplus stocks of residual fuel oil available for export to Japan. Larger shipments of this product as well as petroleum coke more than offset the reduced outflow of light fuel oil, boosting sales of petroleum products 11.6 percent to almost $0.8 billion.

Food and Feed - While Japan proved to be a better market for U.S. agricultural commodities in 1984 than analysts and traders had expected, their generally pessimistic projections for last year were unfortunately on target.

If anything, estimates of corn shipments erred on the high side -- an understandable mistake since, on paper at least, developments in the market for livestock and poultry feed, the end use for roughly three-fourths of corn deliveries, signaled another big-volume year.

The strengthening yen on top of falling international grain and soybean prices allowed feed industry price leader Zennoh, a national federation of cooperatives controlling nearly two-fifths of Japan's feed market, to cut bulk feed prices in 1985 to their lowest levels since the late 1970s. With declines of 6 to 8 percent in the major cost of production for broiler, egg and milk producers and in the second-biggest cost for hog- and beef-finishing operations, Japanese formula feed demand remained on the upswing, shrugging off the dampening impact of weaker farm prices for pork, poultry meat and milk.

Helped paradoxically by greater output of hog rations and broiler feed, compound feed production expanded by a larger margin than forecasters had predicted, extending the string of record-breaking performances to a fourth year. Although relative feed grain prices again meant that sorghum supplied a disproportionate share of the extra volume needed to increase output, feed mills did use some more corn. At any other time, this business would have automatically gone to American exporters, but 1985 was the year the U.S. stranglehold on Japan's feed corn market was broken. Japanese trading companies make no apologies for buying almost one-seventh of the feed industry's corn requirements from China or for purchasing a small volume of Argentine corn for mixing. Not only was Chinese corn priced below American corn on a delivered basis, but it had a higher protein content and a lower moisture level.

Although American corn suppliers needed no reminder that their luck had run out, they still got one. South Africa's normally big share of the Japanese market for corn to manufacture sweeteners, starch and other processed corn products was up for grabs again because of a second year of short supplies. But instead of taking over Japan's industrial corn market as they had in 1984, U.S. exporters were forced to share this business with their new rivals, the Chinese. This double setback threw off predictions of 1985 U.S. corn shipments, as volume dropped one-fifth below 1984's record level. More importantly, the combination of an unexpectedly big fall in shipments and another decline in export prices spelled trouble for the bilateral trade figures: sales of the former number-one U.S. export to Japan contracted 35.1 percent to $1.3 billion.

While higher-than-projected Japanese production of commercially mixed feed was of no help to struggling American corn suppliers, it did get U.S. soybean exports back on track sooner than analysts and exporters alike had anticipated. Their initial pessimism was well-founded, however. Despite a reduction in the 1984 soybean crush, Japanese oilseed processors were still saddled with unusually high soybean meal stocks at the beginning of last year, in large part because 1984 relative protein meal prices had dictated greater use of fish meal and, to a lesser extent, rapeseed meal in compound feed. Moreover, the prospects for working stocks down in 1985 to a level that would support expanded crushing and larger soybean imports seemed bleak no matter how attractively soybeans were priced, given the limited gain predicted for feed production and rising demand for rapeseed oil, particularly in salad dressings.

Much to the relief of U.S. soybean exporters, 1985's sizable increase in formula feed output allowed Japanese oilseed processors to reduce meal inventories ahead of schedule. So did a partial flip in the relative prices of feed ingredients that gave vegetable protein meal an edge on other non-grain inputs last year, although contrary to preliminary indications, rapeseed meal was priced better than soybean meal over the six months starting in April. With stocks back to manageable levels, processors stepped up soybean crushing and at the same time contracted for more imports. While this turnaround rescued U.S. shipments from back-to-back declines, there was a down side for American suppliers: their monopoly on providing all the soybeans crushed by the Japanese industry was broken by Brazil, which received orders for roughly half of the extra volume purchased in 1985. Still, the additional contracts coming to this country helped stop the decline in U.S. sales caused by falling export prices at the $0.9 billion-plus mark, a 20 percent drop.

Capital Goods - A second year of double-digit growth in business spending on plant and equipment not only was the key to Japan's continued domestic economic expansion, but it also made capital goods the one consistent bright spot in an otherwise gloomy 1985 export picture. Paced by big corporations in the electronics, chemicals and automotive industries, the spending boom extended across the full range of investment objectives -- modernization, including automation, capacity expansion, diversification, and the development of new product and process technologies. For most U.S. makers of capital goods, though, bigger Japanese expenditures on modernization/automation remained the ticket to larger export sales.

The expanding market in Japan for factory and office automation equipment certainly provided additional sales opportunities for American manufacturers of computer systems and peripheral equipment if 1985's 14.1 percent jump in exports to $1.3 billion is any guide. What made this gain twice as significant was that it came close to the estimated growth of the Japanese computer market last year, indicating that American competitors successfully defended their eroded market position -- pegged in 1985 at about 30 percent overall and roughly 40 percent in mainframes -- from further encroachment by their Japanese challengers.

Most U.S. companies, whether newcomers to Japan or seasoned market veterans, still rely exclusively on exports of domestically assembled products to supply Japanese customers. But following the path blazed by International Business Machines Corp., a small but rising number of systems makers has opted for a different strategy: manufacturing part of their line in Japan and filling it out with exports from the United States. This approach, which boosted shipments of parts (including subassemblies) to almost $0.6 billion last year, seems to be paying extra dividends. To cite the most obvious example, IBM Japan Ltd.'s 1985 domestic sales climbed 20.7 percent to Y658.6 billion ($3.9 billion at Y170=$1.00), led by brisk shipments of the newly introduced 3090 (Sierra) series of large mainframes, Systems 36 and 38 minicomputers and the 5550 workstation family, the Japanese-language version of the IBM PC. In comparison, Japanese industry leader Fujitsu, Ltd. increased sales at home by roughly 20.8 percent to an estimated Y845.7 billion ($5 billion) in the year ending in March 1986.

While exports of measuring and testing equipment and medical apparatus also expanded again last year, a number of 1984's star sales performers faltered, including semiconductor production and assembly equipment and integrated circuits. What kept capital goods firmly entrenched in the plus column was a rebound in shipments of commercial aircraft, which soared 67.3 percent to $0.9 billion. Continuing to expand and modernize, Japan Air Lines added the 50th Boeing Co. 747 to its fleet, this one a 747-300 for international service, while taking delivery of its first three 767-200s, JAL's replacement for the DC-8 made by McDonnell Douglas Corp. For its part, All Nippon Airways, Japan's major domestic carrier, put eight more 767-200s into operation, bringing its 767 fleet to 21. The number-three Japanese carrier, Toa Domestic Airlines, also upgraded its fleet last year, introducing two McDonnell Douglas MD-80s. Rounding out the list of 1985 aircraft deliveries to Japan, Nippon Cargo Airlines, the country's first all-cargo carrier, added its second and third 747 freighters.

Consumer Goods - The sluggish growth of Japanese consumer spending during the current economic expansion finally caught up with U.S. exports in 1985, cutting sales of consumer durables and nondurables 4.1 percent to $1.4 billion. But hidden behind this figure was some positive news: sales of pharmaceuticals edged up 3.3 percent to $0.6 billion. Coming in the face of a third straight year of flat Japanese drug production and demand, this gain was further proof of the new aggressiveness of big U.S. drug companies in Japan. No longer content to just license their products to Japanese competitors, one after another American multinational is moving toward broad-based local production, usually centered on antibiotics, the biggest-selling drugs in Japan, as well as to direct distribution of its products.

Export Prospects

As difficult as last year was for U.S. companies exporting to Japan, 1986 will be worse. Missing its two main 1984-85 props -- strong overseas sales and robust capital spending, the Japanese economy is likely to continue just muddling along for the rest of the year. This pace will cancel out most of the competitive benefits of the dollar's 40 percent-plus drop against the yen, leaving exports in the minus column.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

JEI Report will not be published July 4, 1986 because of the Independence Day holiday. The next issue will be dated July 11, 1986.

U.S. Exports to Japan by Commodity, 1984 and 1985

(in millions of dollars and indicated quantity units)

Commodity	Quantity 1984	Quantity 1985	Value 1984	Value 1985	Percent Change 1984/85	Japan's Share of U.S. Exports 1985
Total Exports			$23,575.0	$22,630.8	-4.0%	10.6%
Industrial Supplies			9,139.2	8,679.9	-5.0	14.8
Bituminous Coal	16,324,191 stn	15,370,720 stn	865.4	769.1	-11.1	17.5
Coking Coal	15,498,931 stn	13,903,308 stn	829.8	712.9	-14.1	23.4
Steam Coal	825,260 stn	1,467,412 stn	35.7	56.2	57.4	4.1
Petroleum Products			683.1	762.0	11.6	21.2
Light Fuel Oils	3,175,817 bbl	2,534,194 bbl	102.6	74.8	-27.1	11.0
Heavy Fuel Oils	13,579,993 bbl	17,423,590 bbl	369.2	432.6	17.2	24.9
Lubricating Oils			25.8	24.3	-5.8	4.0
Petroleum Coke (excl. calcined)	3,056,909 stn	3,456,521 stn	120.1	157.2	30.9	33.3
Natural Gas	55,618,275 mcf	54,174,547 mcf	262.3	249.1	-5.0	99.5
Nuclear Reactor Fuels			144.1	121.5	-15.7	35.3
Logs and Lumber	2,361,936 mbf	2,523,343 mbf	840.5	884.9	5.3	43.4
Logs	1,759,738 mbf	1,899,035 mbf	641.0	682.2	6.4	54.1
Douglas-fir Logs	914,927 mbf	1,019,640 mbf	325.6	361.7	11.1	60.6
Western Hemlock Logs	631,475 mbf	679,058 mbf	199.1	209.5	5.2	54.9
Lumber	602,198 mbf	624,308 mbf	199.5	202.7	1.6	27.0
Paper Base Stocks			519.9	470.2	-9.6	24.8
Wood Chips	2,191,675 stn	2,169,430 stn	156.6	160.6	2.6	95.1
Wood Pulp	737,697 stn	752,901 stn	327.2	277.6	-15.2	20.5
Waste Paper	308,615 stn	301,417 stn	35.4	31.2	-11.9	8.9
Paper and Paper Products			290.0	288.9	-0.4	13.1
Newsprint	182,620 stn	181,412 stn	86.8	81.6	-6.0	62.1
Kraft Linerboard	164,727 stn	150,149 stn	50.5	38.5	-23.8	8.0
Coated Container Base Stock	130,004 stn	137,127 stn	90.4	97.5	7.9	52.8
Chemicals (excl. plastics, fertilizers and insecticides)			1,536.8	1,513.2	-1.5	14.3
Cyclic Hydrocarbons			80.6	59.2	-26.6	8.5
Styrene	84,558 stn	58,781 stn	46.7	27.3	-41.5	8.7
Para-xylene	18,866,799 gal	20,132,352 gal	32.0	30.6	-4.4	12.8
Acyclic Hydrocarbons			20.3	30.5	50.2	11.3
Cyclic Organic Intermediate Chemical Compounds			142.8	143.2	0.3	11.3
Alcohols, Phenols and Their Derivatives			40.9	57.5	40.6	30.3
Nitrogen Function Compounds and Their Derivatives	23,579 stn	29,154 stn	30.2	36.9	22.2	28.0
Acyclic Organic Chemical Products			340.4	350.0	2.8	15.2
Ethylene Dichloride	247,659 stn	328,939 stn	52.3	58.8	12.4	64.8
Ethylene Glycol	78,719 stn	32,920 stn	28.6	10.9	-61.9	9.8
Acrylonitrile	89,096 stn	85,954 stn	42.5	47.6	12.0	17.0
Vinyl Acetate Monomer	44,011 stn	60,180 stn	21.3	25.2	18.3	20.2
Uranium and Thorium Compounds	561 stn	776 stn	437.7	437.5	-0.1	45.0
Sodium Compounds			49.2	51.1	3.9	8.7
Color Lakes and Toners, Dyes and Paints			31.4	35.6	13.4	8.0
Antiknock Compounds and Additives for Lubricating Oils			68.1	67.5	-0.9	10.4
Compound Catalysts (excl. nickel)			25.3	25.0	-1.2	12.1
Fertilizers and Insecticides			297.7	276.9	-7.0	6.9
Crude Phosphates	1,404,789 stn	777,625 stn	50.8	27.3	-46.3	14.0
Fertilizers			122.2	124.1	1.6	5.7
Diammonium Phosphate Fertilizers	538,275 stn	267,205 stn	92.2	42.9	-53.5	6.7
Unmixed Pesticides			44.1	66.1	49.9	8.8
Manufactured Pesticides			65.4	60.0	8.3	9.8
Plastic and Synthetic Resin Compounds			356.5	305.6	-14.3	8.8
Film, Strips and Sheets			45.7	47.0	2.8	8.2
Synthetic Rubber			56.9	51.0	-10.4	8.7

Commodity	Quantity		Value		Percent Change 1984/85	Japan's Share of U.S. Exports 1985
	1984	1985	1984	1985		
Plastic and Synthetic Resin Compounds			$356.5	$305.6	-14.3%	8.8%
Film, Strips and Sheets			45.7	47.0	2.8	8.2
Synthetic Rubber			56.9	51.0	-10.4	8.7
Tall Oil	51,498 stn	65,698 stn	12.6	34.3	172.2	83.5
Photographic Chemicals			17.6	31.9	81.3	20.0
Still X-Ray Film	55,385,712 sft	54,044,378 sft	38.9	35.6	-8.5	29.1
Still Photographic Film (excl. film packaged for retail sale)	17,240,740 sft	23,018,655 sft	17.3	26.8	54.9	13.9
Photosensitive Papers			29.2	26.7	-8.6	9.7
Steel Scrap	2,680,038 stn	2,110,087 stn	264.9	199.1	-24.8	21.7
Nonferrous Ores and Scrap			363.8	459.6	26.3	30.0
Copper Ore	62,004 stn	113,354 stn	63.7	108.9	71.0	83.1
Molybdenum Ore	3,448 stn	3,515 stn	26.0	26.2	0.8	10.6
Copper Scrap	47,779 stn	42,155 stn	49.7	42.8	-13.9	14.7
Aluminum Scrap	188,051 stn	290,591 stn	184.3	243.7	32.2	69.5
Nonferrous Metals			378.9	289.4	-23.6	19.7
Silver	4,284,194 toz	3,844,196 toz	35.5	24.3	-31.5	26.3
Platinum and Platinum Group Metals	234,766 toz	185,665 toz	67.0	62.7	-6.4	56.9
Copper and Copper Alloys			119.2	16.3	-86.3	5.4
Unwrought Copper	78,567 stn	5,605 stn	107.5	7.9	-92.7	11.2
Aluminum and Aluminum Alloys			226.0	257.7	14.0	27.5
Aluminum Ingot	154,011 stn	218,620 stn	209.9	239.2	14.0	54.2
Unwrought Magnesium	12,042 stn	11,149 stn	28.9	28.6	-1.0	28.6
Zirconium	367 stn	595 stn	19.1	25.0	30.9	48.5
Gold	38,722 toz	84,667 toz	10.9	25.7	135.8	2.0
Iron and Steel (incl. ferroalloys)			63.1	48.4	-23.3	3.9
Tube and Pipe Fittings			28.0	22.4	-20.0	11.1
Silicon			29.7	30.4	2.4	49.4
Unmanufactured Nonmetallic Minerals			100.4	104.8	4.4	14.2
Kaolin Clay	468,450 stn	437,244 stn	61.7	60.2	-2.4	34.5
Other Clays			22.3	28.1	26.0	20.7
Manufactured Mineral Supplies			108.7	111.1	2.2	8.3
Glass (excl. automotive and mirror glass)			29.3	30.7	4.8	9.0
Industrial Textile Fibers, Yarns and Fabrics			67.5	69.3	2.7	2.8
Synthetic Fibers and Manmade-Fiber Yarns			32.2	37.6	16.8	3.2
Raw Cotton	1,588,117 rba	1,065,454 rba	605.1	368.0	-39.2	22.5
Hides and Skins			325.2	298.2	-8.3	27.4
Whole Cattle Hides	7,333,641 pc	6,824,464 pc	305.0	276.1	-9.5	27.8
Leaf Tobacco	46,058 stn	51,002 stn	286.0	302.4	5.7	19.9
Stemmed Flue-Cured Leaf	34,036 stn	31,897 stn	243.5	211.3	-13.2	23.8
Stemmed Burley Leaf	5,460 stn	11,266 stn	40.7	83.2	104.4	27.2
Capital Goods			5,626.6	5,938.6	5.5	6.1
Nonelectric Machinery			3,458.5	3,384.7	-2.1	7.4
Data Processing Equipment			1,166.2	1,331.1	14.1	9.2
Computers			296.6	383.2	29.2	12.2
Peripheral Equipment and Parts			760.2	866.7	14.0	8.1
Disk and Tape Storage Units			85.3	74.4	-12.8	5.5
Terminals			45.2	35.6	-21.2	4.3
Printers			29.7	33.0	11.1	7.2
Parts			484.5	585.3	20.8	8.7
Magnetic Computer Disks and Tapes			28.9	38.8	34.3	11.0
Semiconductor Production and Assembly Equipment and Parts			351.6	276.4	-21.4	25.0
Measuring, Testing and Controlling Instruments and Parts			539.1	553.2	2.6	11.2
Industrial Process-Type Instruments and Parts			56.1	45.9	-18.2	6.3
Chemical Analysis Equipment and Parts			51.5	59.7	15.9	12.4
Physical Analysis Equipment and Parts			55.6	50.5	-9.2	12.7

Commodity	Quantity		Value		Percent Change	Japan's Share of U.S. Exports
	1984	1985	1984	1985	1984/85	1985
Equipment for Testing Electrical, Radio and Communications Circuits and Parts			$191.6	$216.5	13.0%	16.4%
Waveform Measuring and/or Analyzing Apparatus and Parts			36.2	39.7	9.7	16.0
Instruments for Measuring or Testing Combinations of Electrical Characteristics and Parts			78.8	95.9	21.7	19.9
Instruments for Measuring or Checking Electrical Quantities and Parts			42.2	32.4	-23.2	13.7
Scientific, Professional and Medical Equipment			247.1	265.5	7.4	12.1
Electromedical and Electrotherapeutic Apparatus and Parts (excl. X-ray apparatus)			110.6	117.5	6.2	13.2
Medical Equipment Based on X-Rays and Parts			32.3	35.0	8.4	15.4
Other Medical, Dental and Surgical Instruments and Parts			86.4	91.6	6.0	11.4
Power Generating Equipment (excl. aircraft and automotive engines)			307.5	73.3	-76.2	3.6
Auxiliary Plant for Steam and Other Vapor Generating Boilers			85.1	0.5	-99.4	2.3
Gas Turbines and Parts for Mechanical Drives			123.0	17.0	-86.2	3.3
Nonfarm Tractors, Parts and Attachments			45.3	52.4	15.7	3.2
Parts of Tracklaying Tractors			22.1	29.8	34.8	5.8
Excavating and Paving Machinery and Parts			29.2	34.2	17.1	2.2
Drilling and Oilfield Equipment			66.9	68.9	3.0	2.2
Parts and Accessories for Oilfield and Gasfield Drilling Equipment			63.5	63.1	-0.6	2.6
Machinery and Parts for Making or Finishing Pulp, Paper and Paperboard			14.0	27.8	98.6	11.5
Machine Tools and Parts			56.1	59.8	6.6	7.9
Commercial and Industrial Heating and Cooling Equipment and Parts			46.3	42.0	-9.3	6.2
Pumps and Compressors			45.8	49.1	7.2	3.3
Filtering and Purifying Machinery and Parts			39.5	37.0	-6.3	9.3
Taps, Cocks, Valves and Similar Devices and Parts			35.4	35.5	0.3	5.9
Equipment for Service Industries			111.3	120.1	7.9	6.4
Electric Machinery			874.9	804.3	-8.1	5.9
Semiconductors			361.5	235.1	-35.0	5.6
Integrated Circuits			253.7	130.6	-48.5	11.5
Linear Integrated Circuits			81.8	33.6	-58.9	15.7
Chips, Dice and Wafers			69.2	75.7	9.4	3.4
Telephone Equipment and Parts			22.6	38.9	72.1	5.4
Radar Apparatus (excl. for planes and boats) and Parts			63.5	70.8	11.5	12.5
Parts			58.8	67.7	15.1	14.8
Generators, Transformers and Accessories			92.3	75.9	-17.8	5.0
Switches and Relays			22.8	27.5	20.6	8.1
Parts for Generators			30.4	3.5	-88.5	3.1
Connectors			57.4	46.8	-18.5	13.2
Terminals and Electric Splicers			27.0	19.7	-27.0	11.1
Transportation Equipment			1,293.2	1,749.6	35.3	4.7
Civilian Aircraft			541.4	905.9	67.3	13.5
Passenger, Cargo and Combination Jet Transports	10 ut	17 ut	461.6	886.4	92.0	16.1
Used or Rebuilt Planes	8 ut	13 ut	42.8	2.4	-94.4	0.7
Civilian Aircraft Engines, Parts and Accessories			437.5	552.1	26.2	8.8
Jet Turbines			56.0	50.3	-10.2	5.7
Jet Engine Parts			158.6	229.4	44.6	11.7
Parts for Civilian Aircraft			227.1	270.2	19.0	8.5
Railway Equipment, Parts and Accessories			55.7	11.9	-78.6	2.8
Parts for Roiling Stock			43.2	7.4	-82.9	11.9
New Cars	2,044 ut	1,376 ut	29.5	18.8	-36.3	0.3
Automotive Parts, Engines and Bodies			180.2	214.8	19.2	1.5
Engines and Parts			33.3	32.1	-3.6	1.3
Transmissions			23.5	25.6	8.9	2.1

Commodity	Quantity		Value		Percent Change	Japan's Share of U.S. Exports
	1984	1985	1984	1985	1984/85	1985
Food and Feed			$5,929.2	$5,000.7	-15.7%	21.9%
Corn (excl. seed and popcorn)	537,086,560 bu	432,179,039 bu	1,990.2	1,292.6	-35.1	25.0
Sorghum (excl. seed)	87,897,756 bu	95,506,830 bu	269.1	240.9	-10.5	29.9
Soybeans (excl. seed)	152,067,433 bu	157,900,636 bu	1,171.7	937.0	-20.0	24.1
Animal Feeds			172.7	161.2	-6.7	8.5
Dried Beet Pulp	444,437 stn	359,546 stn	58.2	43.9	-24.6	84.9
Alfalfa Hay Cubes	396,409 stn	441,397 stn	51.4	56.8	10.5	90.7
Wheat	124,086,660 bu	114,652,413 bu	534.5	469.0	-12.3	13.3
Barley	16,565,372 bu	6,347,372 bu	46.7	14.2	-69.5	17.9
Fruits and Vegetables			452.6	452.1	-0.1	19.0
Lemons	132,380 stn	120,988 stn	80.4	77.2	-4.0	83.2
Grapefruit	159,517 stn	118,701 stn	51.4	51.5	0.2	55.7
Oranges and Tangerines	96,203 stn	119,097 stn	62.0	73.3	18.2	30.3
Fresh Non-Citrus Fruit			30.6	33.7	10.1	10.8
Almonds			48.3	45.3	-6.2	11.3
Frozen Vegetables			59.5	61.0	2.5	65.0
Frozen French Fried Potatoes	47,393 stn	52,859 stn	30.9	33.8	9.4	81.6
Meat and Meat Products			571.0	540.8	-5.3	46.9
Fresh and Frozen Beef	85,578 stn	91,012 stn	322.2	340.6	5.7	75.0
Fresh and Frozen Beef Offals	38,072 stn	40,133 stn	76.9	76.1	-1.0	30.6
Fresh and Frozen Pork	20,845 stn	10,118 stn	62.1	32.7	-47.3	52.9
Fresh and Frozen Poultry	57,647 stn	51,158 stn	74.6	57.3	-23.2	25.5
Fish and Fish Products			502.9	685.4	36.3	67.5
Fresh and Frozen Whole Salmon	84,910 stn	113,657 stn	261.5	384.9	47.2	83.3
Fresh and Frozen Whole Herring	33,154 stn	37,245 stn	42.9	54.7	27.5	77.5
Fish Roe	15,196 stn	14,042 stn	81.4	99.5	22.2	83.8
Frozen Snow Crab	5,911 stn	9,691 stn	24.3	33.1	36.2	92.1
Consumer Goods			1,475.5	1,415.5	-4.1	11.2
Pharmaceuticals			571.8	590.5	3.3	20.8
Bulk Antibiotics			163.8	167.7	2.4	24.8
Packaged Vitamins			31.5	39.2	24.4	40.6
Blood and Blood Derivatives			146.3	161.5	10.4	43.2
Cigarettes	315,258,900 pk	322,756,950 pk	95.4	94.9	-0.5	8.0
Electric Household Appliances (incl. air conditioners)			50.6	43.5	-14.0	4.2
Stainless Steel Cooking and Kitchenware			77.1	39.0	-49.4	76.9
Records and Consumer Electronics			25.3	34.0	34.4	8.3
Toys and Sporting Goods			90.6	85.7	-5.4	11.7
Golf Equipment			43.2	36.1	-16.4	41.8
Still Film in Cartridges and Rolls	44,567,790 ut	39,890,112 ut	64.0	57.4	-10.3	24.8
Nonwoven Fabrics of Manmade Fibers			33.6	30.6	-8.9	23.7
Clothing			43.1	33.7	-21.8	4.5
Footwear			37.5	34.2	-8.8	30.8
Gem Diamonds and Other Gem Stones			56.3	50.3	-10.7	11.3
Works of Art			34.3	34.8	1.5	10.7
Printed Material			66.0	59.7	-9.5	4.7
Miscellaneous			1,404.5	1,595.9	13.6	7.5
Military-Type Goods			401.6	439.0	9.3	8.1
Other Domestic Exports			521.6	568.2	8.9	5.9
Military Aircraft Engine Parts			326.3	334.2	2.4	11.9
Re-exports			481.3	588.8	22.3	9.5

Key to quantity abbreviations:
bbl = barrels
bu = bushels
gal = gallons
mbf = thousand board feet
mcf = thousand cubic feet
pc = pieces
pk = packs
rba = running bales
sft = square feet
stn = short tons
toz = troy ounces
ut = units

Source: U.S. Department of Commerce, U.S. Exports: Schedule E Commodity by Country (FT 410), December 1984 and December 1985.

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JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

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Japanese Voters Head To The Polls

Japan's double elections, engineered by Prime Minister Yasuhiro Nakasone, have entered the final stages, and candidates are campaigning furiously to overcome the limitations of the short electioneering period. Officially the campaign began June 18 for the upper house and June 21 for the lower house, although the prime minister jumped the gun by making a series of political speeches in mid-June to defend his record on domestic and foreign policy issues.

In the upper house, 506 candidates are vying for 126 seats. (Only half of the 252 seats are subject to election every three years.) Of those, 243 are running for 50 nationwide at-large seats, while the remainder are divided among 76 races in local election districts. In the more important lower house, 837

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Japanese Foreign Assistance: Prospects And Problems

The Japanese Foreign Ministry's preliminary figures for overseas development assistance (ODA) disbursements during the 1985 fiscal year reveal that the overall weakness of the yen prevented Tokyo from reaching its aid-doubling goals for fiscal years 1981-85. Moreover, exchange rate problems, delays in certain multilateral disbursements and sluggish world economic growth all contributed to the largest percentage drop in ODA in 21 years.

The five-year aid doubling plan begun in FY 1981 called for cumulative spending of $21.4 billion by FY 1985. Statistics show that Japan achieved 84.6 percent of that goal, with approximately $18.1 billion in ODA disbursements. A large part of the blame for the shortfall goes to the exchange rate. The yen dropped from an average Y220.54 to the dollar in 1981 to an average Y238.54 in 1985, despite its steep appreciation in the last quarter of 1985. If the yen had held steady or near its January 1981 rate of Y202, when the doubling target was set, the aid goal would have easily been met, according to Foreign Ministry officials.

However, the sharp appreciation of the yen in recent months has boosted the objectives of the new seven-year aid doubling plan announced late last year (see JEI Report No. 44A, November 15, 1985). The new goal is to disburse more than $40 billion by 1992. In light of the yen's current strength and the likelihood that it will probably not plunge again, there is some support in the Foreign Ministry for taking advantage of the exchange realignment and shortening the seven-year target by several years. The prospects for the first year of the new plan already seem bright; even if the ODA disbursement rate remains unchanged from 1985's level, the dollar figure will soar. A new target is under study.

Still, the dollar's strength had a large impact on the 1985 figures. Japan spent $3.8 billion on ODA, a 12.1 percent decline over 1984 spending. The last time such a sharp year-to-year drop in disbursements occurred was in 1963-64, when outlays fell 17.6 percent. The ratio of ODA to Japan's gross national product, one of several international indicators of ODA performance, fell as well, dropping to 0.29 -- the first time in three years that the figure has fallen below 0.3 percent.

According to these statistics, Japan will once again rank as the third-largest ODA donor nation after the United States and France. Comparison and evaluation of the ODA programs of the 17 member-nations of the Development Assistance Committee of the Organization for Economic Cooperation and Development will be announced June 26 following an annual aid meeting in Paris. In 1984 Japan surpassed France to become the second-largest donor nation among DAC participants.

Other factors contributed to last year's decrease in Japan's aid spending, including a big 34.4 percent drop in multilateral assistance. A substantial bottleneck in capital subscriptions and other payments to such agencies as the International Development Association (IDA) has developed. Although Japan's commitments to international financial institutions remain heavy, there is a long lag time between the initial allocation of funds and their actual use. Requests for disbursements originate with the international agency. Sluggish world economic growth has meant agencies like IDA have had a difficult time promoting new loans. Consequently, fewer requests for financial support from Japan and other contributors have been made.

Sluggish economic growth and its impact on ODA distribution is also seen in Japan's aid figures. The pace of loan disbursement by the Japanese aid bureaucracy, such as the Overseas Economic Cooperation Fund (OECF), has slowed over the past two years. The slowdown in the economies of developing nations has hindered efforts to find local financing components for Japanese aid projects. The difficulty of identifying appropriate projects for funding, a perennial problem, compounds the situation.

Concurrently, Japan's ODA program has suffered a major setback both in terms of aid flows and public relations as a result of the change of government in the Philippines, a longstanding ODA recipient. Development assistance was suspended during the course of the political upheaval there, and full reinstatement faces many delays. Scandal taints the entire process. With the end of the regime of Ferdinand Marcos came allegations that Japanese firms and the aid bureaucracy were involved with illegal payoffs in connection with development projects. Tokyo has consequently begun a close examination of past assistance to the Philippines, and reviews of aid distribution procedures have taken on a renewed urgency.

Japan's Official Development Assistance, 1985

(Preliminary figures, in millions of dollars)

	1983	1984	1985	Percent Change
Bilateral ODA	$2,425	$2,427	$2,557	5.3%
Grant Aid	993	1,064	1,185	11.4
Extension of Funds	535	543	636	17.1
Technical Cooperation	458	521	549	5.4
Bilateral Loans	1,432	1,363	1,372	0.6
Multilateral ODA	1,336	1,891	1,240	-34.4
Grants	305	257	286	11.2
Direct Contributions to International Organizations	1,035	1,638	957	-41.6
Loans	-4	-4	-3	--
Total ODA	3,761	4,319	3,797	-12.1
Ratio of ODA to GNP	0.32%	0.34%	0.29%	

Source: Japanese Foreign Ministry

Despite pressure to resume aid activities, officials are gun-shy about the aid relationship. During an early June visit to Tokyo, Philippines Vice President Salvador Laurel, who made several public requests for increased assistance, was told by Foreign Minister Shintaro Abe that Japan would increase its grants and technical assistance under certain conditions. Aid officials explain that Tokyo wants the Philippines to establish a stable decisionmaking process for aid projects, clearly elucidate its aid needs, and straighten out its bookkeeping before reestablishing major aid flows.

The Japanese government also wants to avoid more embarrassing incidents of the kind created recently when Manila rejected several Japanese assistance projects. The new Aquino government canceled four projects arranged last December as part of an aid package negotiated with the Marcos regime, claiming that they were too closely linked with Mr. Marcos and his business cronies. In late May, following a period of great uncertainty, the OECF announced the conclusion of a $97.6 million loan for the Philippines to fund the seven remaining development projects.

Sheri Hoptman

New Lifetimes For Japanese Capital?

Urged on by the yen's appreciation, the Ministry of Finance is paying more attention to revising the current depreciation system. Japanese business groups have complained for many years about the current system of recovering capital costs and have pointed to the U.S. system with envy (see JEI Report No. 45A, November 30, 1984). MOF, on the other hand, has hesitated to revise the scheduled life of plant and equipment or to alter calculation methods because it will surely reduce revenue. But the reduction in Japan's international competitiveness brought about by the yen's steep rise seems to have dislodged MOF from this entrenched position.

Although the current schedule of plant and equipment lifetimes has been adjusted several times in the past 25 years (see Table 1), the changes have been modest. From the point of view of most business leaders, the last significant change was made in 1966 when the useful lifespan of plants and structures ~~was~~ reduced an average 15 percent.

While some observers might consider this stability a plus since it allows for effective long-term corporate investment planning, most businessmen feel that the system has failed to keep pace with current demands. They point out that even before President Reagan instituted the accelerated cost recovery schedule in 1981, U.S. tax law allowed plant and equipment to be depreciated over a considerably shorter time than in Japan (see Table 2). The accelerated cost recovery system, they continue, has given U.S. firms an even greater advantage in writing off capital costs. For items such as automotive manufacturing equipment or semiconductor plants, U.S. lifetimes are 40 to 50 percent shorter than Japan's. The gap is very important in high technology industries where heavy, consistent capital investment is absolutely vital.

The Finance Ministry has been studying the problem for many years, but both because of the yen's rise and a Tax Commission report calling for a thorough review, finally seems to be ready to act. MOF has informally proposed the following changes: a simplification of plant and equipment classifications; the reduction of current statutory lifetimes by 10 to 20 percent; and an increase in the current maximum depreciable amount from 95 percent to 100 percent of the purchase price. MOF estimates that these changes will mean Y1 to meaning there will be little or no reduction in the competitive pressures felt by foreign firms.

Jon Choy

Table 2: International Comparison of Statutory Life of Plant and Equipment

(in years)

	Japan		United States				
	Normal	ADR	ACRS	CCRS	Britain	West Germany	France
Structures							
Administrative use	65	45	18	28	25	50	25
Retail use	60	60					20-50
Manufacturing/storage	45	45					20
		60					
Equipment							
Spinning	10	9	5	7	*	7-10	7-10
Weaving	10	9				7-10	
Petrochemical	9	7.5				10	
Oil and gas	8	13				8-12	
Iron and steel	14	12				5-10	
Nonmetallic refining	9	11				8-12	
Metalworking machinery	10	9.5				5-15	
Electric machinery	11	8				5-15	
Automotive machinery	10	9.5				5-12	
Shipbuilding, repair	12	9.5				5-12	

*fixed amount (25 percent) depreciation

Notes:
ADR - Accelerated Depreciation Recovery
ACRS - Accelerated Cost Recovery Schedule
CCRS - Capital Cost Recovery Schedule

Source: Ministry of International Trade and Industry

Japan-Latin America Trade

Japan-Latin American trade is characterized by Japanese exports of manufactured products, particularly machinery, in exchange for a variety of raw materials. Crude oil accounted for four-fifths of Mexico's shipments to Japan in 1985, while oil and aluminum accounted for 84 percent of Venezuela's. Chile and Peru exported copper and iron ore; Argentina shipped various agricultural products; and Brazil's major exports were iron ore and coffee.

In contrast to its $8.9 billion deficit with the ASEAN countries (Thailand, Singapore, Malaysia, Brunei, Philippines and Indonesia) in 1985, Japan on paper registered a trade surplus with Latin America (see Table 1). The total figures, though, are misleading; ships accounted for five-sixths of Japan's exports to Panama, a reflection of the many international shipping companies incorporated in that country. If that item is excluded, Japan ran a $568 million deficit with Latin America.

Table 1: Japan's Trade with Latin American Countries

(in millions of dollars)

	1981		1985	
Country	Exports	Imports	Exports	Imports
Panama	$2,210	$131	$3,326	$81
Mexico	1,705	1,437	994	1,870
Brazil	1,367	1,578	615	1,840
Puerto Rico	346	52	725	108
Venezuela	925	912	352	368
Chile	742	531	169	534
Argentina	785	281	225	443
Colombia	497	150	422	150
Peru	350	602	141	332
Cuba	267	154	301	92
All Latin America	10,516	6,669	8,486	6,242

Source: Japan Tariff Association

The debt crisis, which began in Mexico in August 1982, has significantly reduced Japanese exports to the region. Shipments to the 10 major Latin American debtors fell from $6.8 billion in 1981 to $2.9 billion in 1983 (see Table 2). Another decline in 1985 reduced exports to this group to only 1.8 percent of total Japanese exports, compared to 4.5 percent in 1981. This has contributed to Japan's rising dependence on the U.S. market, whose share of Japanese exports rose from 25.4 percent in 1981 to 37.2 percent in 1985.

Table 2: Japan's Trade with Major Latin America Debtors*

(in millions of dollars)

Year	Exports	Imports	Balance
1981	$6,831.7	$5,942.4	$889.3
1982	4,897.9	5,580.6	-682.7
1983	2,873.6	5,871.1	-2,997.5
1984	3,277.5	6,462.8	-3,185.3
1985	3,154.9	5,619.9	-2,465.0

*Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, Venezuela.

Source: Japan Tariff Association

The decline in Japanese shipments paralleled the drop in U.S. exports to Latin America debtor nations, which fell from $35.2 billion in 1981 to $19.3 billion two years later, before rising to $24.3 billion in 1985. But the debt crisis has had a more significant impact on the United States since these countries are a more important market for this country, accounting for 15 percent of total exports in 1981. In 1985 they accounted for only 11.4 percent of U.S. exports.

There was no sign of improvement in Japan's exports to the region during the first three months of 1986. In dollar terms, shipments rose 12.6 percent from the year earlier, reflecting the appreciation of the yen. But valued in yen, exports were down 16.6 percent. Imports, which have been much less volatile during the past five years, showed a similar tendency, up 15.8 percent in the first quarter valued in dollars but down 13.2 percent in yen terms.

Randall S. Jones

Gold Card System To Expedite High Technology Exports

"It is the first significant reform of the export licensing system in many, many years -- decades," declared Steven Bryen, deputy under secretary of Defense for trade security policy, after the Reagan administration recently announced expedited procedures for the export of high technology items. During a June 17 press conference, officials unveiled what amounts to an overhaul of U.S. export controls policy: U.S. exporters will no longer have to go through cumbersome licensing procedures when dealing with a select group of foreign end-users.

Instead of applying for a license to sell controlled items to foreign firms and governments, American firms will simply have to verify that the overseas purchaser is a pre-approved end-user that has demonstrated compliance with regulations prohibiting the sale or re-export of sensitive products to the Soviet Union or other Eastern bloc countries. The new system will reportedly reduce the approval time for high technology sales from an average eleven days to only one to two days. A list of reliable end-users, dubbed "gold card" holders by administration officials, is currently being compiled. They will be certified by the Commerce Department for an initial two-year period and publicly identified once the regulations take effect.

Trade officials admitted that intense congressional criticism of current export control procedure had prompted revision of the regulations. Business groups had urged Congress to act on their complaints that national security considerations were hampering overseas sales (see JEI Report No. 8B, February 28, 1986). In response, the omnibus trade bill approved by the House of Representatives in May requires the current list of items controlled through licensing procedures to be cut by 40 percent. The administration maintains that about 80 percent of the products currently controlled could qualify for expedited treatment if sold to purchasers on the gold card list.

The new regulations, expected to be in place by this fall, will be applied first to the member nations of the Coordinating Committee for Multilateral Export Controls (COCOM), which includes Japan and NATO member nations.

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MACROECONOMIC INFLUENCES ON THE U.S.-JAPAN TRADE IMBALANCE
A STUDY BY VINCENT REINHART OF THE FEDERAL RESERVE BANK OF NEW YORK*

Summary

The dramatic depreciation of the dollar against the yen since September 1985 should brake the seemingly nonstop erosion of the U.S. trade deficit with Japan, but it will take more than the return of the dollar-yen rate to its 1980 position to roll back the bilateral imbalance. As Vincent Reinhart of the Federal Reserve Bank of New York demonstrates in the following article, a major cause of the widening trade gap in the 1980-85 period was the slowdown in real economic growth in Japan relative to activity in this country. His colleagues, Daniel E. Nolle and Charles Pigott, also show in an accompanying article that the surge in U.S. purchases of capital goods from Japan -- the main source of Japanese import gains during the first half of the 1980s -- was in large part the result of the composition of domestic investment spending.

Introduction

From 1980 to 1985, the U.S. merchandise trade deficit increased by $100 billion to nearly $125 billion. Both the size and rapid growth of our trade deficit are unprecedented. While the imbalance is distributed widely across major trading partners, Japan accounts for the largest share, about one-third of the total or $43 billion in 1985. Not surprisingly, therefore, the deficit

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with Japan has attracted the most attention. Economists and policy makers generally agree that the large U.S.-Japan trade imbalance is not sustainable over the long run and that it poses a serious threat to trade relations between the two countries, but there seems to be no agreement on causes of the imbalance or potential remedies for it. Indeed some have questioned whether it can be remedied at all.

One view, shared by many in the U.S. Congress, is that the bulk of the imbalance reflects explicit or implicit protectionist barriers and "unfair" trading practices in Japan. Under this view, the only viable option for the United States is to enact legislation restricting imports from Japan. In contrast, many economists believe that the U.S. trade deficit with Japan is part of a set of broader macroeconomic imbalances, which can be reduced by policies encouraging stronger economic growth in Japan and improved U.S. competitiveness. Still others have argued that Japan's bilateral and global surpluses reflect specific cultural factors, the often-noted high saving rate and a preference for home products -- that are immune to legislative action as well as to macroeconomic policy.

This article focuses on the macroeconomic forces underlying the U.S.-Japan trade balance during the 1980s. The increasing bilateral deficit coincided with significant changes in other economic trends in the two countries, including a slowing of real growth in Japan relative to the United States and a spectacular rise in the dollar against the yen and other major currencies. An assessment of the contributions of these macroeconomic developments to the bilateral trade deficit has important implications for economic policy. More specifically, if a substantial part of the deficit has been generated by changes in exchange rates and real growth, then macroeconomic policy can play an important role in reducing that deficit. On the other hand, if cultural differences or other structural factors account for Japan's trade performance, the medium-term prospects for substantial reductions of the bilateral deficit would seem to be limited.

The analysis in this article, based on a recently estimated model of U.S.-Japan trade, suggests that macroeconomic influences were responsible for most of the rise in the bilateral deficit since 1980. The dollar's marked appreciation from 1970 to early 1985 seems to account for about one-third of the increase in the U.S.-Japan trade deficit over that period. Another 40 percent is attributable to a narrowing of the U.S.-Japan growth differential, reflecting, largely, slower growth in Japan during recent years. Looking to the future, our analysis suggests that the substantial decline of the dollar against the yen and other currencies since early 1985 should reduce the bilateral imbalance over the next several years. However, without a significant pickup in Japan's real growth relative to the United States our trade deficit with Japan will most likely continue to be well above historical levels.

Influences on Trade

In several respects, the trade deficit with Japan has followed a pattern set by the overall U.S. trade imbalance. Both deficits increased moderately between 1980 and 1982 and then much more rapidly over the next three years.

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Between 1980 and 1985, the $33 billion increase in the U.S. deficit with Japan was one-third of the total rise in the deficit (Chart 1). Indeed, in dollar terms the U.S. balance with Europe has deteriorated even more.

These deficits also reflect an unprecedented growth in U.S. imports accompanied by near stagnation of exports (Chart 2). From 1970 to 1975, U.S. imports from Japan more than doubled, increasing $34 billion. The volume increase was nearly as great since the average price of these imports changed little. In the same period, U.S. exports to Japan posted only a $1.3 billion increase.

Trade developments went hand-in-hand with two other major shifts in economic trends. First, the U.S.-Japan growth differential narrowed as the rate of increase in Japanese GNP slowed to barely above that of the United States from 1980 to 1985. This represents a marked departure from the 1970s when the average annual increase in U.S. real GNP was 3.7 percent compared with 8.7 percent for Japan. The growth in Japanese domestic demand slowed even more, so that the U.S. market was expanding faster than the Japanese market. Since a part of any increase in aggregate demand is spent on foreign products, this recent shift in growth patterns would be expected to slow U.S. exports to Japan relative to imports.

Second, the dollar appreciated dramatically from the end of 1980 to the beginning of 1985, with increases of 22 percent against the yen and an average of 50 percent against other currencies (Chart 3). This appreciation, by raising the costs of U.S.-produced goods relative to foreign-produced goods, stimulated U.S. imports from Japan and depressed our exports. Since the dollar appreciated more against other currencies than it did against the yen, the cost of U.S. goods rose relative to Japanese goods and rose even more relative to the other foreign goods that compete in the Japanese market. Thus, U.S. exports to Japan were hurt by increased competition both from Japanese goods and from other foreign goods in the Japanese market.

The potential importance of these changes for the bilateral deficit is strongly suggested by economic theory as well as past experience (Table 1).[1] When Japan's real GNP grew faster than that of the United States, our bilateral exports and imports increased at roughly the same rate, and the bilateral imbalance remained within moderate bounds. When Japanese growth slowed toward the U.S. rate over 1978-79, U.S. imports from Japan accelerated and the deficit grew. These observations indicate that trade between these two countries is affected by their GNP growth rates and that Japanese imports are substantially less responsive to Japanese GNP than U.S. imports are to our GNP. Other studies of U.S.-Japan trade support these observations.[2]

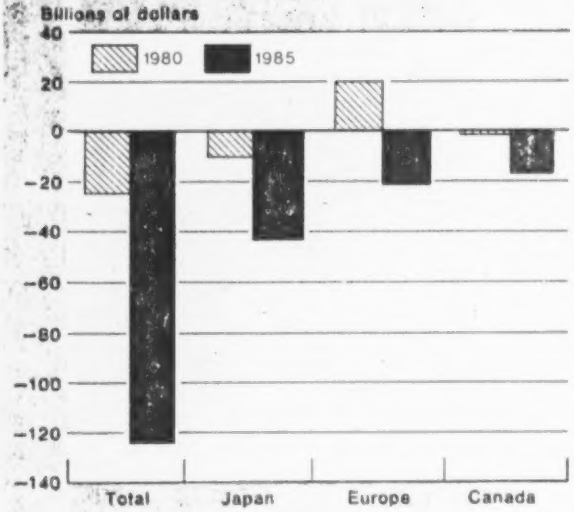
[1] For a review of the theoretical issues, see Morris Goldstein and Moshin Kahn, "Income and Price Effects in Foreign Trade," in Ronald Jones and Peter Kenen, eds., Handbook of International Economics, Volume 2 (1985).

[2] There have been many studies on the sensitivity of total imports to income (usually GNP). The average of estimates in the recent literature suggests that our imports, in volume terms, increase by 2 percent for every 1 percent rise in our real GNP. In contrast, an increase in Japan's income of 1 percent raises that country's import volume by about 1 percent. The divergence between the estimated bilateral elasticities reported later in the text is even greater.

Chart 1

United States Trade Balance by Region

Annual rates

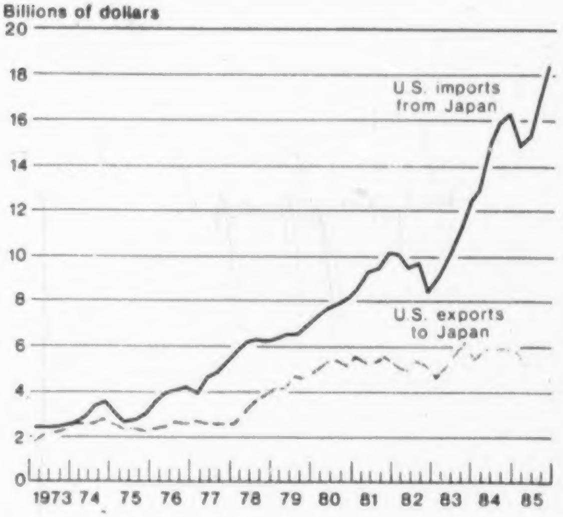


Source: United States Department of Commerce.

Chart 2

United States-Japan Trade Flows

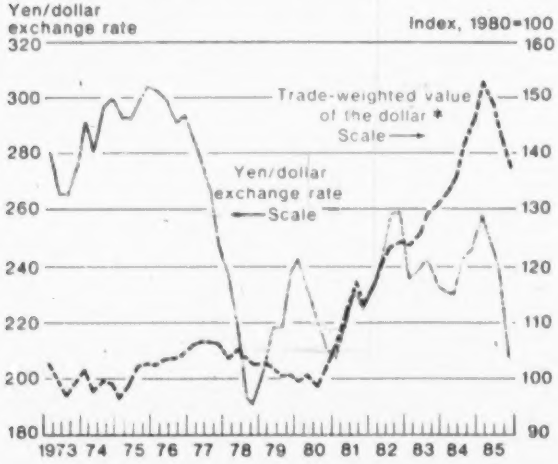
Quarterly rates



Source: United States Department of Commerce.

Chart 3

The Exchange Value of the Dollar



*Trade-weighted exchange value of the dollar vis-à-vis 11 industrial countries, excluding Japan.

Source: International Monetary Fund, International Financial Statistics.

Table 1: United States and Japan Growth and Price Trends

(average four quarter percent change over period indicated)

	1975/IV-1973/I	1978/IV-1975/IV	1982/IV-1978/IV	1985/IV-1982/IV
Japan				
Real GNP	1.5	5.0	3.9	4.5
Domestic demand	0.6	5.3	2.4	3.5
United States				
Real GNP	0.2	4.9	-0.2	4.4
Domestic demand	-0.5	5.3	0.4	5.8
U.S. export volume to Japan	-8.8	13.3	3.3	5.2
U.S. import volume from Japan	-7.5	18.4	2.4	30.5
Relative price of Japanese goods in the U.S. market	2.2	2.2	-3.1	-1.3
Relative price of U.S. goods in the Japanese market	5.5	-10.8	5.[illegible]	-6.3

Less obvious from past experience is the impact of the rising dollar on the deficit. However, the fact that growth in U.S. imports from Japan has been extraordinarily rapid since 1980 would seem to imply that the dollar has been a major influence.

The historical perspective suggests that shifts in two basic macroeconomic forces -- relative growth rates and exchange rate changes -- played a major role in the widening U.S.-Japan trade deficit since 1980; it still does not reveal anything about the extent to which the increased deficit can be attributed to those forces individually or collectively. To examine this issue more closely, we estimated a standard model explaining trade flows in terms of real growth rates, inflation, and exchange rate changes over the 1972-82 period. The volumes of U.S. exports to and imports from Japan are assumed to depend on the countries' incomes and prices of traded goods relative to domestic goods. The prices of U.S. and Japanese products as well as those of other countries are included because Japanese goods compete in the U.S. home market not only with American goods but also with the products of other countries. The prices of traded goods are themselves determined by exchange rates combined with the general level of costs within the exporting country and demand conditions within the importing country. Thus the value of the dollar against the yen as well as other currencies influences U.S.-Japan trade through its impact on relative prices. (Further details of the model and estimates are given in the box.)

Table 2 presents the model's prediction of changes in the bilateral balance between 1980 and 1985 and the relative contributions of income growth,

The Estimated Trade Model

The U.S.-Japan model is an empirical representation of simple supply and demand frameworks for two markets: U.S. trade in imports from Japan and Japanese trade in exports from the United States. We estimated the sensitivities of the volumes and prices of traded goods to incomes, prices, and exchange rates with regressions using quarterly data from 1972 to 1982. The independent variables in the export volume equation (XV) were the level of Japanese domestic demand (Y) and the price of U.S. exports to Japan relative to Japanese prices (XP/JPP). All prices were converted into dollars.*

Import volume was estimated as a function of U.S. GNP (Y), import prices from Japan relative to U.S. home prices (MP/USP), and a lagged dependent variable. The import volume equation was corrected for serial correlation (u).

Estimates are reported in Table B-1 and provide support for the proposition in the text: U.S. imports are much more sensitive to income than are U.S. exports. Equal permanent increases in income of one percentage point in the United States and Japan would raise the volume of U.S. imports from Japan by 3.2 percent but would only raise the volume of exports to Japan by 1.2 percent in the long run (Table B-2). Balanced growth in the United States and Japan results in imbalanced bilateral trade. Further, both the export and import volume equations reveal important own-price effects. In the long run a 1 percent increase in import prices will lower the volume of imports from Japan by 1.7 percent. A 1 percent increase in export prices will lower the volume of exports to Japan by 1.0 percent. It is perhaps important to point out that the differences in the estimated income and price elasticities for the two countries depend on, among other things, institutional and cultural factors. In other words, changes in those factors can alter the role of macroeconomic influences. For example, the estimated income elasticity of imports for Japan might be significantly higher if Japanese domestic markets were more open to foreign goods. This subject is, however, beyond the scope of the present study.

The dollar prices of exports (XP) and imports (MP) were related to measures of production cost, competitors' price (FORP), and domestic goods prices. The pricing equations estimated indicated that there are varieties of "pass-through" depending on the pattern of the change in exchange rates and domestic demand conditions. Since competition from other foreign countries must be considered, both the dollar's value against the yen as well as all other currencies will affect prices and volume of traded goods. The historical relationships from the 1970s used in the model suggest that a permanent 10 percent increase in the yen/dollar rate would lower the dollar price of imports by about 3 percent and raise the yen price of exports by about 3 percent in the long run. This incomplete pass-through limits the ability of exchange rates to influence trade flows. If the dollar were to appreciate 10 percent against all currencies, dollar import prices would decrease about 9 percent and yen export prices would increase about 8 percent.

Table B-1
Estimation Results

Export volume: $$XV = \underset{(0.12)}{-0.24} + \underset{(1.92)}{0.31Y} - \underset{(2.34)}{0.26(XP/JP)} + \underset{(8.94)}{0.74XV_{-1}}$$
$R^2 = 0.91$
D.W. = 2.26

Export price: $$XP = \underset{(0.05)}{0.03} + \underset{(1.13)}{0.07JPFORP} + \underset{(1.08)}{0.05JPP} + \underset{(13.46)}{1.46XP_{-1}} - \underset{(6.63)}{0.61XP_{-2}}$$
$R^2 = 1.00$
D.W. = 2.02

Import volume: $$MV = \underset{(3.29)}{-8.13} + \underset{(3.81)}{1.55Y} - \underset{(2.13)}{0.83(MP/USP)} + \underset{(4.52)}{0.51MV_{-1}} + \underset{(1.92)}{0.32u}$$
$R^2 = 0.94$
D.W. = 1.84

Import price: $$MP = \underset{(6.46)}{1.62} + \underset{(0.94)}{0.06USP} + \underset{(3.04)}{0.22USFORP} + \underset{(3.12)}{0.11JPP} + \underset{(8.79)}{0.61MP_{-1}}$$
$R^2 = 1.00$
D.W. = 1.93

Table B-2
Long-Run Bilateral Trade Elasticities

The impact of a permanent 1 percent change in:	U.S. Exports to Japan		U.S. Imports from Japan	
	Volume	Price	Volume	Price
Home country income	1.2	n.a.	3.2	n.a.
Traded goods price	-1.0	n.a.	-1.7	n.a.
Foreign competitors' price	0	0.5	0	0.6
Producers' cost	n.a.	0	n.a.	0.3
Domestic goods' price	n.a.	0.3	n.a.	0.2

---

*The bilateral export and import price indexes were constructed using geometrically weighted averages of U.S. export and import deflators by major end-use group. The weights were the shares of each commodity group in U.S. exports and imports from Japan.

exchange rate change, and inflation.[3] The main point that emerges from Table 2 is that developments in macroeconomic factors are, in large part, responsible for the deterioration of the bilateral trade position, accounting for $27 billion of the $33 billion recorded increase in the deficit. The unexplained portion is therefore small, though obviously not insignificant. The dollar value of both bilateral exports and imports increased more than would be predicted from past relationships, but increases in U.S. exports to Japan exceed predicted values by a considerably smaller margin. This relative success in explaining exports indicates that the widening of the deficit over and above what macroeconomic variables predict is not the result of special Japanese import practices.[4]

Table 2: The Change in the United States-Japan Trade Balance, 1980-85

(in billions of dollars, annual rates)

Change	Nominal exports	Nominal imports	Nominal balance
Actual	1.3	34.3	-33.0
Predicted	-1.2	26.3	-27.5
Of which attributed to:			
Income growth	2.7	16.2	-13.5
Exchange rate change	-4.1	8.2	-12.3
Other*	0.2	1.9	-1.7
Unexplained	2.5	8.0	-5.5

*Includes the influences of inflation in the United States, Japan, and other foreign countries.

Of those macroeconomic forces, the rise in the dollar accounted for a significant portion of the increases in the bilateral imbalances. If the dollar exchange rate had remained unchanged from its 1980 level against the yen and other currencies, the 1985 deficit would have been about $12 billion lower; that is, about one-third of the increase in the deficit is attributable to exchange rate movements. This calculation takes into account only the direct effect of the exchange rate on prices of traded goods, and assumes away any indirect effect on trade through changes in incomes or other macroeconomic variables. Moreover, with the dollar exchange rate fixed, macroeconomic developments, including real growth rates, would probably have been different from

[3] This was a dynamic simulation of the model. Wherever lagged endogenous values were called for the model's own forecasts were used.

[4] On the other hand, as shown in the next article by Nolle and Pigott, nonmacroeconomic forces have influenced U.S. imports from Japan in recent years. This may account for the relatively large prediction error in our import estimates over 1980-85.

what actually occurred, and as a result, trade flows and even the balance might have evolved along different lines. Abstracting from these difficulties, our results suggest that even if the dollar had not appreciated since 1980, other macroeconomic forces would likely have driven the bilateral deficit to over $25 billion by 1985.

The bilateral deficit would have widened due to the pattern of U.S.-Japan real growth. The increases in the two countries' GNPs would have led to a nearly $14 billion worsening in the deficit due exclusively to the effects of income on the volumes of trade. These effects are concentrated on the import side. Income growth influences the demand for foreign goods directly; when income grows, so does the demand for foreign goods. In contrast, exchange rate changes affect trade volumes more indirectly through first altering the prices of traded goods. On the basis of the estimated model, U.S. imports from Japan are almost three times as sensitive to income as U.S. exports to Japan. This differential sensitivity to income implies that Japan's real income must grow at nearly three times the U.S. rate to maintain balanced increases in export and import volume (absent any changes in relative prices). These changes in income directly affect the volumes of exports and imports but not the prices of traded goods.

By contrast, the exchange rate influences both the volumes and prices of traded goods. For example, if the dollar appreciates, the dollar cost of foreign goods declines. Typically, some fraction of these lower costs will be passed-through to lower prices, which then stimulates import demand. The exchange rate effect on price works in the opposite direction of the price effect on volume, so the impact of a change in the dollar on the nominal value of imports is less than on the volume of imports.[5] On the export side, the effect of an appreciating dollar is to lower the dollar price of exports, but not enough to prevent them from becoming more expensive relative to Japanese home goods.[6] Export volume declines and the price effect reinforces the volume effect. Exchange rates, therefore, have a bigger impact on nominal exports than on real exports. As Table 3 shows, about 80 percent of the predicted change in the real balance can be accounted for by dollar movements, making them even more important in explaining real trade flows than nominal trade flows.

Medium-Term Prospects For The Trade Balance

We can use this historical perspective on the relationship between the deficit and its key macroeconomic determinants to suggest how the balance will evolve over the next few years. Since one of the trends that greatly influenced the deterioration of the balance from 1980 to 1985 has substantially

[5] Indeed, the initial impact of an exchange rate depreciation may be to increase prices by proportionally more than volume declines; consequently, imports in nominal terms increase. Over time, the volume declines dominate and the nominal imports decline. This reversal in the path of imports is known as the "J-curve."

[6] Put another way, an appreciating dollar raises the yen costs of exports. If the pass-through to a higher yen price is less than complete (which is likely), then the dollar price of exports will decline.

Table 3: The Change in the United States-Japan Trade Balance, 1980-85

(in billions of 1980 dollars, annual rates)

Change	Volume of exports	Volume of imports	Real Balance
Actual	2.0	31.4	-29.4
Predicted	-1.9	24.7	-26.6
Of which attributed to:			
Income growth	3.0	15.4	-12.4
Exchange rate change	-2.1	17.6	-19.7
Other*	-2.8	-8.3	5.5
Unexplained	3.9	6.7	-2.8

*Includes the influences of inflation in the United States, Japan, and other foreign countries.

reversed itself in 1985 and into 1986, we will explore whether the depreciation of the dollar during the last year will be sufficient to restrain any further deterioration in the deficit.

In the first quarter of 1986 the yen/dollar rate was 27 percent below its year-earlier level. There were similar, if smaller, declines against the other major currencies. Our historical perspective suggests that such a large movement in U.S. relative to Japanese costs should have a significant impact on trade flows. Whether the trade balance actually improves will depend not only on the exchange rate effects but also on developments in other variables, especially the pattern of income growth in the two countries.

The direct effect of income on the bilateral balance would likely, by itself, lead to a widening deficit for two reasons. First, since U.S. imports from Japan are more income-sensitive than U.S. exports to Japan, equal rates of growth in export and import volumes require that Japanese income growth be almost three times that of the United States. Second, given the present deficit, U.S. exports to Japan must grow at a proportionately faster rate than imports simply to prevent further deterioration.[7]

The model can be used to assess the relative contributions of exchange rate change and income growth to the future course of the deficit. Assuming that income in both countries grows close to long range trend (3.0 and 4.5 percent for the United States and Japan, respectively, the behavioral relationships embedded in the trade model suggest that a fall in the yen/dollar rate to 180 (along with the dollar's general decline against all other currencies) is enough to lower the 1988 bilateral balance by $12 billion from what it would have been without any exchange rate change. This only considers the direct effects of alternative exchange rate paths on trade flows. If the exchange rate were different that would obviously influence the paths of domestic income and prices. These macroeconomic linkages are not taken into account in our comparison. More favorable assumptions about the pass-through and the price sensitivity of trade volume would, at most, mean another $3 to $5 billion reduction of the deficit from what it would have been in 1988. For the bilateral balance to improve substantially, the growth in real domestic demand in Japan would have to accelerate or relative prices would have to undergo further changes.

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[7] In 1984 import volume was 2.2 times export volume. If the volume of imports were to remain fixed at the 1984 level forever and export volume were to grow at its 15 year historical average of 5.4 percent per year, volumes of trade would not balance until the year 2004.

Conclusion

The sharp rise in our trade deficit with Japan during 1970-85 seems to have resulted largely from shifts in key macroeconomic factors. The analysis in this article indicates that about four-fifths of the increase in the deficit can be attributed to changes in exchange rates and in the relative patterns of real growth and prices in the two countries. The rise of the dollar played a major role in aggravating the bilateral trade imbalance, but the deficit would have widened substantially even if exchange rates had remained at their end-1980 levels. Slower income growth in Japan led to a narrowing of the growth differential and accounted for about 40 percent of the widening of the trade imbalance.

Since macroeconomic variables can explain most of the deterioration in our trade position with Japan from 1980 to 1985, the perception that "unfair" trading practices or protectionism in that country has contributed substantially to the increase in the deficit appears to be unfounded. Even granting that the initial bilateral trade gap in 1980 may have been due, largely, to the relatively closed nature of Japanese markets or other structural forces, our analysis suggests that the bulk of the present U.S.-Japan trade imbalance reflects macroeconomic factors. It would seem more appropriate, therefore, to look for macroeconomic solutions to narrow the trade imbalance between the two countries.

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THE CHANGING COMMODITY COMPOSITION OF U.S. IMPORTS FROM JAPAN

A STUDY BY DANIEL E. NOLLE AND CHARLES PIGOTT
OF THE FEDERAL RESERVE BANK OF NEW YORK*

Introduction

The last several years have brought a surge in U.S. imports from all areas of the world. Especially rapid has been the growth in Japan's sales to the United States, which nearly doubled between 1980 and 1985 and now amount to one-fifth of our total imports (Chart 1).

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Magnifying the impact of U.S. purchases from Japan is their high and increasing concentration in key manufacturing sectors previously dominated by domestic producers. Nearly one in five new cars sold domestically is produced in Japan. Japanese capital goods, led by personal computers and other high technology equipment, have been the fastest growing component of imports since 1980. Indeed, last year nearly 7 percent of all investment equipment expenditures by U.S. businesses went to Japanese exporters.

As with our imports generally, purchases from Japan have been boosted substantially by the dollar's rise over 1980-85; presumably, the dollar's recent decline should slow their growth considerably. But whether Japan's most impressive gains in the United States will be reversed is less clear. Quality and cost-efficiency, and rapidly growing U.S. domestic demand, have also contributed to Japanese successes. These factors, together with the dollar's movements, will ultimately determine whether Japan's role in U.S. markets diminishes or continues to increase.

This article examines recent trends in U.S. imports from Japan for the major commodity groups, focusing on capital goods and autos. After identifying the major shifts among the categories since 1980, we analyze the reasons for the changes, and then assess their implications for Japan's future position in U.S. markets. U.S. purchases of Japanese capital goods have grown especially rapidly and their share, both of our domestic market and of total imports from Japan, has increased. The dollar's appreciation over 1980-85, relatively rapid U.S. real demand growth, and a change in the composition of domestic investment spending appear to be largely responsible for this shift. Our analysis suggests that despite the dollar's fall, U.S. producers will continue to face stiff competition from Japan, and that Japan's share of our total imports is likely to remain high by historical standards.

Commodity Composition

Considerable diversity underlies the remarkable growth of Japanese exports to the United States since 1980: not all categories have fared equally well. Indeed, the commodity composition of our imports from Japan has changed markedly in recent years. These changes reveal that Japan's success in U.S. markets has been less pervasive than is often supposed.

As shown in Table 1, imports of consumer goods (except autos) and industrial supplies from Japan have grown in line with our imports of these products from other areas. Japan's share of total U.S. imports in these categories has changed little since 1980. Our imports of these products from Japan have grown faster than demands for domestic products but so have imports from other areas.

More striking have been the divergent performances since 1980 of the two leading components of U.S. imports from Japan, capital goods and autos. Their current positions also represent a reversal of the 1970s pattern. During most of the 1970s and early 1980s, autos were the dominant U.S. import from Japan, accounting for nearly 40 percent of the total; capital goods were second in importance, but they only moderately exceeded consumer goods and industrial

~~supplies~~ shipments. Spurred by strengthening demand for small cars due to rising gasoline prices, Japan's share of total U.S. auto imports rose rapidly during the mid- and late 1970s, as did its share of the overall U.S. market (Chart 2). By the end of 1980, just before the voluntary export restraint (VER) was imposed, Japanese producers had garnered one-fifth of the U.S. market for new cars.

Since 1980, however, growth in Japanese auto exports to the United States has slowed considerably, and their share of total auto imports has dropped by five percentage points.[1] But a surge in U.S. purchases of capital goods from Japan has more than compensated for the sluggishness in autos. Imports of Japanese capital goods have grown nearly five times faster than domestic demand and 50 percent faster than overall capital goods imports. As a result, capital goods now challenge autos as Japan's leading export to the United States. Japanese producers' share of the domestic market has more than doubled, from 3 percent of business investment equipment expenditures in 1980 to 7 percent in 1985.

The rapid growth of Japanese capital goods imports is largely responsible, in an accounting sense, for the increase in Japan's share of total U.S. nonpetroleum imports over the last five years from 19 percent in 1980 to 24 percent in 1985. This increase would have been even greater if the Japanese share of auto imports had not declined.[2] That capital goods have been the fastest growing component of total imports only adds to the significance of Japan's gains; Japanese producers have strengthened their position in one of the most buoyant sectors of our market.

Determining Factors

Our analysis suggests that the performance of Japanese exports is due not only to macroeconomic trends, such as the dollar's appreciation, but to other factors as well. For example, the most obvious explanation for the relatively slow growth of U.S. auto imports from Japan lies with the VER imposed in 1981. Because of the VER, sales of Japanese autos in this country reportedly have fallen short of demand in recent years.

Capital goods imports from Japan and elsewhere were stimulated by U.S. investment growth during the 1983-85 business expansion,[3] as well as the boost to foreign competitiveness provided by the dollar's appreciation. However, because the dollar rose less against the yen than other major currencies,

[1] Auto imports from Japan grew more slowly in real terms than total auto imports and U.S. demand over 1980-84, but rebounded in 1985 following an increase in the VER quota. The drop in Japan's share of auto imports partly reflects the slower growth in the price deflator for Japanese autos compared with the deflator for auto imports as a whole.

[2] Note, however, that because of the rapid growth of capital goods, Japan's share of total imports would have increased over 1980-85 even if its shares of individual categories had remained fixed at their 1980 levels.

[3] Nearly three-quarters of the increase in capital goods imports over 1980-85 occurred during the recovery from the 1982 recession.

Table 1: Import Growth by Major Categories

(in percent; trade data for 1985 are preliminary)

	Automotive goods*	Capital goods	Consumer goods	Industrial supplies**
1980-85 real growth:				
U.S. imports from all areas	10	15	14	6
Imports from Japan***	10	24	16	7
Domestic demand	8	5	3	4
Japan's share of U.S. imports:				
1976	29	26	19	13
1980	42	24	18	11
1985	37	33	20	11
Memo: Composition of total U.S. imports from Japan:				
1980	37	23	20	17
1985	36	32	20	10

*Includes auto parts.

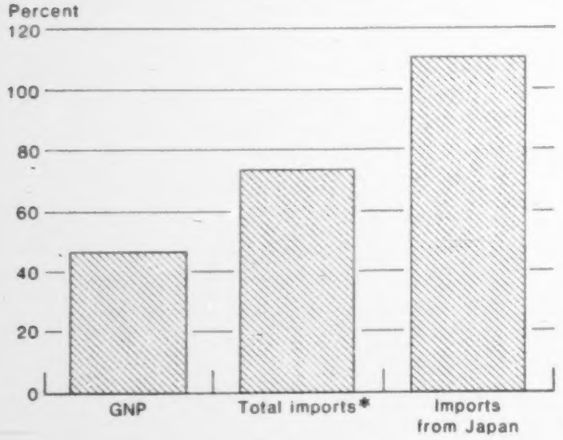
**Nonpetroleum supplies.

***Separate import-price indexes for U.S. purchases from Japan are not available. Real growth of these imports was calculated using measures of Japanese production costs, converted to dollars at prevailing exchange rates, as deflators of nominal imports in each category.

Chart 1

Growth of United States Imports and GNP

Cumulative 1980-85 growth in current dollars

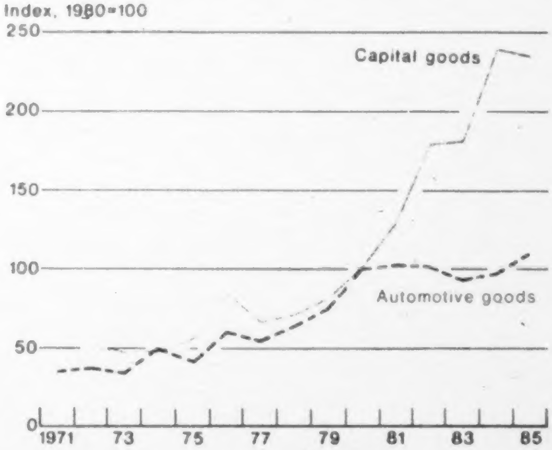


*Nonpetroleum imports.

Source: United States Department of Commerce.

Chart 2

Japan's Penetration of United States Markets*



*Index of the ratio of U.S. imports to domestic demand (in the relevant sector) in constant dollars.

Source: United States Department of Commerce.

Japanese exporters may have benefited less than their European competitors. Probably more favorable to Japan has been the shift in U.S. investment spending toward office and store equipment, primarily small computers and copiers. This equipment accounted for 26 percent of producers' durable expenditures in 1984, up from 16 percent in 1980 and less than 10 percent in the mid-1970s. Japan has benefited significantly from this shift because it is the major foreign producer and exporter of this type of capital equipment.[4]

The relative importance of these factors is of special interest because some of the conditions spurring Japan's gains into the United States are now changing. The most obvious is the dollar's depreciation, an average of 20 percent from its 1985 peak, and to more than 25 percent below its 1980 level against the yen. But other conditions that have favored Japanese exports may continue. New developments that could further enhance the position of Japanese producers, such as relaxation of the VER on autos, cannot be ruled out. Thus the extent to which Japan's advances in our markets will continue, or recede, is not obvious.

To make this assessment, we have used a statistical analysis of the determinants of U.S. imports from Japan during the 1970s to estimate the major contributors to their growth over the 1980s. This analysis also provides a basis for judging the outlook for future competition between the two countries.

As explained further in the box, imports in each category are largely determined by several factors: domestic demand for all products of that type; production costs in Japan (and possibly other countries) compared with those in the United States; exchange rates; and several industry-specific factors. For example, an increase in U.S. producers' durable equipment spending should raise demand for Japanese capital goods; increases in Japanese production costs or dollar depreciation should lower imports by raising selling prices or reducing the yen profits to Japanese exporters. In addition, the share of domestic investment in office/store equipment may significantly affect U.S. demand for Japanese capital goods, while higher gasoline prices should favor demand for fuel-efficient Japanese cars.

Table 2 indicates the expected growth of each type of Japanese import over 1980-84 based on these factors.[5] The expectations are very close to the actual increases recorded for capital goods and industrial supplies. U.S. auto imports from Japan grew much more slowly than past relations would suggest, probably because the VER kept actual purchases below the level of demand.

[4] Office and related equipment accounted for about one-third of total U.S. capital goods imports in 1985, compared with 10 percent in 1980. Japan now supplies 45 percent of these imports, with Asian developing countries supplying another 30 percent. Imports of this equipment from Asian developing nations have grown more rapidly than imports from Japan. European and Canadian capital goods exports are heavily concentrated in industrial machinery.

[5] Though final complete data for 1985 were not available, preliminary figures indicate that they would not change our conclusions.

How Different Are U.S. Imports From Japan?

The exceptional growth in U.S. imports from Japan might suggest that there is something unusual about their determinants. However, our statistical analysis of individual categories implies that U.S. demands for Japanese products are largely unexplainable in terms of factors governing comparable U.S. imports from other areas. Much of the distinctive behavior of aggregate imports from Japan is attributable to their commodity composition, as well as the commodity composition of U.S. demand.

As with purchases from other countries, imports of particular Japanese products (e.g., autos) are heavily influenced by two sets of factors: domestic demand for products of the given type (i.e., cars in general);* and Japanese exporters' production costs compared to those of U.S. and foreign competitors. Costs determine the price at which a supplier can sell and the profit earned. A rise in Japanese costs is apt to lower our imports, either by raising prices or reducing the exporter's profit. Exchange rates affect imports by altering their cost: a rise in the dollar against the yen, for example, lowers the cost, expressed in dollars, of Japanese exports relative to their U.S. competitors. In many cases, imports from European and other foreign countries will compete with Japanese products, and if so, their costs and exchange rates may also affect our imports from Japan (see Appendix).

Other industry-specific factors also seem to have affected our imports significantly. Increased capacity utilization in our domestic durable goods industries seems to encourage capital goods purchases from Japan, probably by slowing deliveries from U.S. competitors. The share of our investment spending going to office/store equipment is positively related to demand for Japanese capital goods, as is the relative price of gasoline to demand for Japanese autos (see table).

The figures in the table confirm that the response of imports from Japan to demand and exchange rate changes is generally similar to that of imports from other areas. Except for industrial supplies, domestic demand growth is associated with more than proportionate increases in imports. This implies that growth itself tends to raise the share of Japanese exports in the U.S. market (although, except for consumer goods, the increase is fairly modest). This pattern is not unique to Japanese products, however. Industrial nations' imports generally seem to respond more than proportionately to their income growth, helping to explain why import-to-GNP ratios have been rising over time. Indeed, the Japanese responses to demand shown in the table are, in general, fairly close to those derived in a recent study by Christopher Rude** of total U.S. imports in each major category.

Imports from Japan also seem to be about as responsive to exchange rates as other comparable U.S. imports.*** Capital goods imports appear fairly sensitive to changes in the dollar, even though its appreciation seems to have played only a modest role in import growth over 1980-84. The main reason is that strong demand growth dominated the impact of the more modest change in the yen/dollar exchange rate. Auto imports from Japan appear insensitive to exchange rates, but the Rude study suggests that this is the case for U.S. auto imports generally. This insensitivity may also be a statistical illusion. Because the quality of Japanese autos generally has been rising, the measures used in the analysis may overstate true costs and hence mask their influence on imports, as well as the effect of exchange rates. The relative price of gasoline does seem to have been a major influence on our demand for Japanese autos during the 1970s, substantially accounting for their rising share of the domestic market. However, because energy prices since have changed little, this factor appears to have been much less important during the first half of the 1980s.

Finally, our analysis suggests a reason for the especially rapid growth of imports from Japan during U.S. economic recoveries.**** Business investment, and hence demand for capital goods, are procyclical; that is, they normally grow faster than GNP during business-cycle expansions. Capital goods imports are also procyclical, more so than other major import categories. On this basis, the relatively high capital goods share of Japan's exports to the United States helps explain their more rapid growth than overall U.S. imports during recent expansions. Note, however, that investment and demand for capital goods typically slow substantially as the economy approaches full employment and GNP converges toward its "potential" growth path. For this reason, imports from Japan should not be expected to outstrip our GNP indefinitely.

Response of Real Imports from Japan to Demand and Exchange Rate Changes
(in percent)

Import Response	Capital goods	Automotive goods	Consumer goods	Industrial supplies
One percent increase in demand	1.3	1.3	1.9	0.8
One percent rise in dollar versus:				
All currencies	1.5	0	2.2	1.0
Yen only	1.5	0	0.7	2.2
One percent increase in office equipment share of U.S. investment	3.3	n.a.	n.a.	n.a.
One percent rise in gasoline price	n.a.	0.9	n.a.	n.a.

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*Demand is measured by producers' durables spending for the capital goods equation, consumer spending for consumer goods, domestic auto expenditures for autos, and industrial production for industrial supplies.

**Christopher Rude, "The Role of the Dollar in the Changing Composition of U.S. Trade, 1980-84," unpublished working paper, Federal Reserve Bank of New York (April 1986).

***The aggregate (volume) elasticity of imports from Japan with respect to changes in the dollar is 1.0; for imports excluding autos it is 1.6.

****This pattern was pronounced during the 1976-78 and 1983-85 expansions, when imports from Japan grew much more rapidly than total imports and U.S. GNP.

Table 2: Sources of the Growth in Imports from Japan, 1980-84

(changes in billions of 1982 dollars)

Sources	Capital goods	Automotive goods	Consumer goods	Industrial supplies
Actual*	11.7	4.2	4.9	1.9
Predicted	12.0	9.3	2.7	1.7
Of which attributed to:				
Dollar appreciation	2.9	1.0	3.6	1.1
U.S. activity	4.7	7.6	1.7	0.9
Office equipment demand**	4.8	***	***	***
Other	-0.4	0.7	-2.6	-0.3
Unexplained	-0.3	-5.1	2.2	0.2
Memo: Cumulative growth 1980-84 (in percent)				
Actual	176	34	83	37
Predicted	180	73	47	29

*U.S. imports from Japan deflated by Japanese costs of production expressed in 1982 prices.
**Measured by the share of office equipment in U.S. producers' durables expenditures, and applicable for capital goods only.
***Not included.

Table 2 also suggests that the dollar's appreciation has contributed significantly to the overall growth of imports from Japan, particularly in consumer goods and industrial supplies where it seems to have been the single most important factor. But the dollar appears to have had less influence on the growth in demand for Japanese capital goods and autos.

Instead, the overall growth and composition of U.S. investment spending appear to account for nearly 80 percent of the exceptional increase in capital goods imports from Japan. Half of this is attributable to the ten percentage point increase in the office/store equipment share of producers' durable equipment spending. In effect, Japan's increased share of our capital goods market largely reflects its concentration in the most rapidly growing component.

In autos as well, domestic activity has been the dominant contributor to demand for Japanese imports.[6] In fact, the figures in Table 2 imply that imports of Japanese autos would have grown nearly twice as fast as actually recorded over 1980-84 if the VER had not been imposed. Although this amount may

[6] Auto imports from Japan seem relatively insensitive to exchange rate changes, although for reasons discussed in the box, this may be understated.

be overstated,[7] it seems likely that Japanese auto producers would have penetrated significantly further into the U.S. market had it been free from these restraints.

Prospects

Economic conditions prevailing over the last several years have greatly favored U.S. demand for Japanese exports at the expense of domestic products. With the decline in the dollar, falling gasoline prices, and generally slower U.S. real growth, these conditions are now less favorable. Accordingly, growth of imports from Japan should slow significantly over the next several years. But whether these changes will be sufficient to roll back Japanese gains in our markets since 1980 is doubtful. One reason is that the share of investment spending going to office equipment is likely to remain high;[8] another is that decelerating demand for Japanese autos may not be reflected in imports.

Table 3 gives a projection of the position Japanese exporters might hold in U.S. markets after the fall in the dollar has fully affected demand. This should not be taken as a forecast but as an illustration of how recent changes in U.S. economic conditions could affect our imports from Japan.

As might be expected, the dollar's decline should curtail the rapid growth of imports from Japan of the last several years. Indeed, these imports probably will fall in real terms over the next one or two years, in sharp contrast to the first half of this decade. Nonetheless, the projection suggests that roughly 40 percent of Japanese gains since 1980 in the capital goods market will persist, primarily because the composition of domestic investment spending seems likely to continue to favor Japanese producers.

Interestingly, because of the changed energy situation, Japan's share of the U.S. auto market may shift little even if the VER is removed. The reason is that falling gasoline prices could lower demand for Japanese autos nearly back to the level permitted by the quota, largely removing its effective constraint on imports for several years.[9]

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[7] About half of the residual can be attributed to the VER assuming that Japan's share of auto imports would have remained at the 1980 level in its absence. Allowing for some further increase in Japan's share suggests that perhaps three-quarters of the difference between actual and predicted growth is attributable to the VER. The rising cost of gasoline was a major factor behind the growth of Japanese auto imports after 1973 but became much less important during the 1980s.

[8] In part, spending on office equipment reflects an increased concentration of investment services, including wholesale and retail trade. This pattern should persist, at least to a large extent, over the next several years.

[9] The Table 3 projections assume that three-quarters of the difference between actual and predicted growth in imports of Japanese autos over 1980-84 was due to the VER. If all of the difference is allocated to the quota, its removal would allow a somewhat greater increase in Japan's market share.

Table 3: Projected Medium-Term Outlook for Imports from Japan*

(in percent)

	Capital goods	Autos**		Consumer goods	Industrial supplies
		With VER	Without VER		
Ratio of real imports to real domestic demand (index, 1980 = 100)					
1985	230	110	n.a.	180	115
Projected	145	110	115	105	75
Memo: Projected average real import growth over the first two years of the projection horizon	-12	3	5	-13	-14

*Projected positions after several years assuming: U.S. real demand grows at 3 to 4 percent; the dollar stays roughly 25 percent below its 1985 average against the yen and 10 percent below its 1985 average against other foreign currencies; the relative price of gasoline stays about 30 percent below its 1985 average; and the office/store equipment share of producers' durables spending is unchanged from the 1985 level.

**Projection with VER assumes imports and domestic demand grow at the same rate. Projection without VER assumes that three-quarters of the 1980-84 residual growth given in Table 2 is restored over the projection horizon.

Overall, then, the U.S. propensity to buy Japanese products is likely to remain high. For U.S. producers, this means that competition with Japan in domestic markets (as well as in foreign markets) will continue to be fierce. Japanese producers will probably maintain their present share of the U.S. auto market for the foreseeable future -- and could make further inroads if oil and gasoline prices recover.. And unless the dollar declines further, or the office equipment share of investment drops significantly, Japanese exporters are likely to capture at least 5 percent of domestic capital goods expenditures, more than double their 1980 share.

Trade Balance

Finally, the gains made by Japanese exporters also have implications for the U.S. trade deficit with Japan. Restoration of balance in U.S. trade would bring a substantial decline in our nearly $50 billion deficit with Japan.[10] Nonetheless, the commodity composition of the two countries' overall trade means that Japan's share of U.S. imports is likely to continue to exceed the

[10] See the preceding article.

share it takes of our exports.[11] In effect, even when its overall trade is in balance, the United States is likely to have a trade deficit with Japan -- although a much smaller one than at present.

Substantially because of its inroads in capital goods, Japan's share of total U.S. imports is now five percentage points higher than in 1980. Our analysis suggests that much of this gain will persist. Growth in imports from Japan should decline over the next two to three years, but so should import growth from other areas. The likely composition of investment spending is apt to prevent Japan's share of U.S. capital goods imports from falling substantially below its present level of one-third; and Japan's share of auto imports could as easily rise as fall. On this basis, Japan's share of our overall imports could remain significantly higher than in the late 1970s, perhaps by as much as two to three percentage points or $5 to $8 billion in 1985 prices.[12] If so, restoration of overall balance to U.S. trade is likely to leave a significant deficit with Japan.

Conclusion

By past standards, U.S. imports from Japan have grown very rapidly during the 1980s. The United States now buys almost as much from Japan as it does from Canada, its primary trading partner. To many observers, this performance reflects a combination of Japanese production skills and determination to export that will not be easily offset by the dollar's depreciation.

Our analysis has shown, however, that Japanese producers have not been equally successful in U.S. markets. Capital goods is the only major category where imports from Japan have grown more rapidly than those from other areas. But this growth has been so strong that Japan's aggregate share of U.S. imports has increased -- despite the voluntary export restraint on Japanese autos.

Japanese inroads into our markets also appear to be due at least as much to economic conditions in the United States as in Japan. Because of the overall composition of its production, Japan was well-positioned to benefit from the surge in U.S. imports during the 1980s that resulted from our strong domestic demand growth and the dollar's appreciation. Together with a shift in the composition of U.S. investment toward office equipment, these macroeconomic trends largely account for the very rapid growth of Japanese capital goods exports to the United States.

As a result of the dollar's sharp decline, Japanese exports to the United States are apt to grow little, if at all, in nominal terms over the next

[11] Japan's imports are dominated by raw materials while its exports are primarily manufactures. For this reason, Japan typically has trade deficits with LDC exporters of raw materials and trade surpluses with the industrial countries. Furthermore, the commodity composition of U.S. imports is similar to that of Japan's exports; autos and capital goods together account for two-thirds of Japan's exports, and nearly half of U.S. (nonpetroleum) imports.

[12] The estimate reflects the increased importance of autos and capital goods in total U.S. imports, as well as Japan's increased share of capital goods.

two years, and should decline in real terms. The result should be a significant improvement in the U.S. trade deficit with Japan. Nonetheless, as long as the composition of U.S. investment is favorable to Japanese capital goods exporters, Japan's share of our imports probably will remain high by pre-1980 standards.

* * * * * *

APPENDIX: The Statistical Model

The statistical model includes equations for imports from Japan for capital goods, autos (including parts), consumer goods, and (nonpetroleum) industrial supplies. The form is log-linear, with the dependent variable the value of imports from Japan divided by an index of Japanese production cost converted to dollars at the prevailing exchange rate.* The predetermined variables (expressed in logarithms) are U.S. real activity in the relevant category,** the ratio of U.S. to Japanese production costs, the ratio of third-country to Japanese production costs,*** and industry-specific variables. Capacity utilization in durable-goods industries and the ratio of office/store equipment spending to total producers' durables expenditures are the industry-specific variables in the capital goods equations; an index of the ratio of gasoline prices to the CPI was included in the autos equation. The equations were estimated using quarterly data over 1971-80.

*Import data are from United States Commerce Department published sources. Japanese production costs were measured by the export unit value index for autos, and by wholesale price indexes for the other categories.

**The demand variables are producers' durables spending, the value of consumer auto purchases, consumption, and industrial production -- all expressed in constant (1972) dollars.

***This variable was not included in the autos equation because of lack of data; it was dropped from the capital goods equation because of a statistically insignificant coefficient.

(See table on page 21)

U.S. Imports from Japan by Major Commodity Group: Estimated Equations*

(t-statistics in parentheses)

Independent variables	Dependent Variables			
	Capital goods	Automotive goods	Consumer goods	Industrial supplies
U.S. cost/Japan cost**	1.46 (4.06)	0.03 (0.09)	2.17 (2.45)	1.03 (2.29)
Third countries cost/Japan cost**	*** ***	*** ***	-1.46 (-1.90)	1.17 (2.13)
U.S. activity	1.26 (3.21)	1.27 (4.47)	1.86 (2.16)	0.84 (1.23)
Capacity utilization in U.S. durable goods	0.01 (1.17)	*** ***	*** ***	*** ***
Share of office equipment in U.S. producers' durables	0.03 (2.36)	*** ***	*** ***	*** ***
Gasoline price index	*** ***	0.90 (7.03)	*** ***	*** ***
Constant	-13.74 (-2.99)	-10.99 (-2.44)	-19.16 (-1.63)	-7.17 (-1.22)
Autocorrelation coefficient	0.68 (11.35)	0.52 (3.67)	0.73 (7.13)	0.60 (4.65)
F statistic	24.32	27.31	1.94	5.65
R^2 (adjusted)	0.97	0.93	0.78	0.64
Regression standard error	0.07	0.11	0.09	0.11

*All variables were expressed in natural logarithms, except capacity utilization in U.S. durable goods industries and the share of office equipment in U.S. producers' durables.

**Estimates refer to the total (sum of current and lagged) impact. A second order polynomial distributed lag (4-6 quarters) was used.

***Not included.

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JAPAN · ECONOMIC · INSTITUTE

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The Elections: Oh What A Feeling!

The Liberal Democratic Party scored an overwhelming victory in Diet elections July 6, winning 300 of the key lower house's 512 seats and 72 of the 126 contested seats in the upper chamber. The Nakasone strategy of holding double elections clearly paid off, as voter turnout of over 70 percent reestablished not simply a working majority for the LDP but uncontested dominance in the nation's parliament.

The election results surprised even LDP loyalists, who had projected gains of seven to twenty seats in the lower house from the party's pre-election position of 250 seats. Polls conducted shortly after the lower house was dissolved on June 2 suggested modest gains for the Liberal Democrats, but little confirmation was available until the final days of the campaign. (Major news organizations may have been gun-shy after their 1983 electoral predictions showed the LDP ahead of its competitors when in fact the party lost 36 seats in the lower house.) A Yomiuri Shimbun survey published July 3 suggested that the LDP, which had been forced into a coalition with the New Liberal Club in 1983 to retain its control over the Diet, would easily win nearly 240 seats and could pick up an additional 23 to 43 if voter turnout was high and the nation's political mood favored the LDP on election day. Even this relatively optimistic forecast proved conservative, as voters swept the party to its strongest numerical position in the Diet in postwar history. After adopting conservative independents into its ranks, the LDP will enter the next session of the Diet, which must be convened within 40 days of the election, with 304 seats.

The LDP's lower house gains came primarily at the expense of the largest opposition party, the Japan Socialist Party, which lost 20-plus seats, dropping its total to 85. Although its performance was off from the 1983 election, Komeito (the Clean Government Party) remained the number-two opposition party. The Democratic Socialist Party lost almost one-third of its strength, while the Japan Communist Party's showing remained unchanged.

Election Results

	Lower House		Upper House	
	1983	1986	1983	1986
Liberal Democratic Party	250	300	68	72
Japan Socialist Party	112	85	22	20
Komeito	58	56	14	10
Democratic Socialist Party	38	26	6	5
Japan Communist Party	26	26	7	9
New Liberal Club	8	6	--	--
United Social Democratic Party	3	4	--	--
Independents/Others	16	9	9	10
Total	511	512	126	126

The election results suggest that the average voter has yet to feel the negative effects of the strengthened yen and subsequent downturn in the Japanese economy. Election issues -- such as they are in Japan -- focused primarily on "pocketbook" questions, including the likelihood of a tax increase (see article in this issue). Foreign policy played a minor role in the debate, except to the extent that it affected personal economic considerations. For example, Prime Minister Yasuhiro Nakasone explained the strong yen in terms of its economic benefits -- such as lower energy costs. And, appealing to Japanese patriotism, he argued that the yen-dollar realignment was an apt reflection of the strength of the Japanese economy internationally, a point on which voters should take pride. Other controversial subjects, such as possible Japanese participation in the Strategic Defense Initiative, received little attention at the grassroots level.

The elections clearly indicate that the major opposition groups in Japan have yet to offer a credible alternative to the programs pursued by the ruling LDP in the last three decades. In personal terms, the balloting was disastrous for JSP chairman Masashi Ishibashi, who has tried for two years to turn the party in a more moderate direction in recognition of the LDP's popularity and the conservative nature of Japanese voters. Mr. Ishibashi may very well be forced to resign in the election's aftermath as a result of the JSP's lackluster performance. This could exacerbate an already emotional split between the center and left wings of the party, further diluting its chances for the future.

The major factions within the LDP all gained seats, but significantly, the results for the Nakasone faction are mixed. Although accurate totals are not yet available, the Takeshita/Tanaka faction came out well ahead, pinning down 140 members of the two chambers, with the Nakasone, Suzuki/Miyazawa and Fukuda/Abe factions all having from 75 to 85 members. While the Nakasone faction gained the second-highest number of new members, it still ranks fourth in size. Unaligned members of the LDP will be pursued in the weeks to come in an effort to shore up the strength of individual factions.

A key consideration concerns the legacy of the Tanaka faction. This group remains partially intact because former prime minister Kakuei Tanaka -- its virtually bedridden leader --- was re-elected to his seat in the lower house. Although the faction remains nominally Mr. Tanaka's, two members -- LDP vice president Susumu Nikaido and Finance Minister Noboru Takeshita -- are locked in a struggle for the leadership post.

In this respect, the elections could have been better for the prime minister. A major element in the long-term Nakasone strategy has been to translate his popularity among voters into real factional influence. While the results probably enhanced his position within the LDP, particularly since he pursued double elections with such determination, they failed to produce an equally dramatic factional realignment.

LDP executive council chairman Kiichi Miyazawa may have suffered a setback as well, although the faction backing him fared well in the balloting. The former foreign minister resisted the call for elections until the last minute, grudgingly accepting reality only in the name of party unity. The overwhelming LDP victory would seem to have discredited his position, even though the party may push stimulative economic policies that he has long promoted.

Speculation on the relative strength of the remaining "New Leaders" -- Mr. Takeshita and Foreign Minister Shintaro Abe -- is rampant and confusing, but it appears that should a succession struggle ensue -- a likely possibilty despite Mr. Nakasone's repeated assurances to "abide by LDP rules" and step down as party president in October -- Mr. Takeshita would be the frontrunner at this point. For one thing, his financial support has reportedly been stronger than his rivals'. For another, Mr. Abe's supporters are said to prefer waiting out this race unless he is the undisputed leader of the pack. Mr. Abe is also the youngest contender, which gives him more opportunities in the future.

But Mr. Nakasone has emerged with election results that may have exceeded his wildest dreams, providing him with leverage and an argument that cannot be denied: Despite the current slowdown, the country's economic prospects have never been better and the LDP is in the strongest position in its 30-year history. Those are tough arguments to beat from a man the pundits declared dead almost three years ago.

Michael W. Chinworth

visits to the Yasukuni Shrine and emphasis on Japanese-style patriotism, the prime minister is likely to interpret the results as an endorsement of his vision of Japan's future and a further sign that by leading the LDP to an unprecedented position, he has assured his place in Japanese history.

Michael W. Chinworth

Japanese GNP Declines In 1986's First Quarter

Slumping exports in the first three months of 1986 drove Japan's gross national product down 0.5 percent in real terms from the previous three-month period (see Table). It was the first quarterly decline in the economy since 1975 when rising oil prices sparked a recession. The fall in GNP, which translated into a 2.1 percent decline in annual terms, intensified support for expansionary fiscal and monetary policies to boost the economy.

Despite the contraction, inflation-adjusted growth in fiscal 1985 (April 1, 1985-March 31, 1986) met the government's revised forecast of 4.2 percent, a modest decline from FY 1984's 5 percent growth rate. In nominal terms, Japan's GNP increased 5.9 percent to Y321,065 billion ($1.9 trillion at Y170=$1.00) in fiscal 1985, indicating continued low inflation.

The disappointing performance in the January-March quarter was primarily the result of an 18.2 percent fall (at an annual rate) in real exports, the third consecutive quarterly decline. The yen value of shipments was reduced as a result of the appreciation of the yen, which averaged Y187.9=$1.00 in 1986's first three months, a 26.1 percent rise from its September 1985 rate. In addition, the volume of exports was unchanged from its first quarter 1985 level. The decline in exports was partially offset by a slump in imports, which also fell for the third consecutive quarter.

Exporters, anticipating the continued drop in shipments abroad, curtailed capital spending in 1986's opening quarter. After three consecutive periods of double-digit increases, business investment rose only 1.4 percent at a real annual rate in the first three months of 1986. There were signs of strength, however, in other components of GNP. Consumer spending increased 2.7 percent -- the best showing in a year -- despite a deteriorating employment situation and modest wage increases. Moreover, residential construction rose 10.3 percent, its biggest quarterly increase since 1983. Excluding the drop in net exports, therefore, the economy expanded at an 1.3 percent annual pace in the first quarter.

For FY 1985 as a whole, inflation-adjusted exports rose 2.2 percent, a sharp decline from the previous fiscal year's 15.8 percent increase. But the external sector remained an important source of growth, as the rise in exports combined with a 1.7 percent decline in imports raised net exports 18.9 percent. Still, growth was more domestically oriented in fiscal 1985: external demand accounted for just 0.7 percentage point of the 4.2 percent growth rate, compared to 1.3 percentage point of FY 1984's 5 percent expansion.

Business investment increased by 12.6 percent in real terms in FY 1985, its second straight double-digit rise. But this impressive growth partially reflected the inclusion of capital spending by the newly privatized Nippon

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1984	FY 1985	April-June 1985	July-September 1985	October-December 1985	January-March 1986
Gross National Product	Y281,102.2 (5.0%)	Y292,838.4 (4.2%)	Y289,437.3 (5.7%)	Y291,379.9 (2.7%)	Y295,529.9 (5.8%)	Y293,959.8 (-2.1%)
Personal Consumption Spending	159,100.7 (2.6%)	163,326.1 (2.7%)	161,900.4 (2.0%)	162,777.8 (2.2%)	163,661.5 (2.2%)	164,746.8 (2.7%)
Private Residential Construction	13,688.4 (0.4%)	14,197.8 (3.7%)	14,227.9 (9.3%)	13,881.0 (-9.4%)	14,188.1 (9.1%)	14,539.1 (10.3%)
Private Fixed Nonresidential Investment	47,342.6 (10.9%)	53,294.0 (12.6%)	51,114.2 (22.6%)	52,981.2 (15.4%)	54,303.4 (10.4%)	54,487.1 (1.4%)
Change in Business Inventories	1,839.1 (86.0%)	1,637.8 (-10.9%)	1,825.3 (-44.2%)	1,438.2 (-61.4%)	1,838.4 (167.0%)	1,471.9 (-58.9%)
Government Current Expenditures	26,654.9 (2.3%)	27,360.0 (2.6%)	27,081.5 (1.5%)	27,192.9 (1.7%)	27,369.9 (2.6%)	27,796.4 (6.4%)
Government Fixed Investment	22,159.9 (-3.0%)	20,641.0 (-6.9%)	19,954.0 (-27.4%)	20,495.6 (11.3%)	20,924.9 (8.6%)	20,794.1 (-2.5%)
Change in Government Inventories	159.1 (*)	307.2 (*)	77.6 (*)	515.6 (*)	604.4 (*)	17.5 (*)
Net External Sector	10,157.3 (49.2%)	12,074.5 (18.9%)	13,256.4 (103.7%)	12,097.6 (-30.6%)	12,639.3 (19.2%)	10,106.9 (-59.1%)
Exports of Goods and Services and Factor Income Received	53,609.8 (15.8%)	54,793.3 (2.2%)	57,176.9 (18.2%)	55,077.6 (-13.9%)	54,720.5 (-2.6%)	52,036.1 (-18.2%)
Imports of Goods and Services and Factor Income Paid	43,452.4 (10.0%)	42,718.8 (-1.7%)	43,920.5 (1.7%)	42,980.0 (-8.3%)	42,081.2 (-8.1%)	41,929.2 (-1.4%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

Telegraph and Telephone Corp. and Japan Tobacco Inc. in the figures for the private sector; excluding investment by these organizations, the increase stood around 9 percent. At the same time, Tokyo's continuing fiscal austerity meant that the government again made a meager contribution to growth; current expenditures rose 2.6 percent in the April 1985-March 1986 period, while investment declined 6.9 percent.

Randall S. Jones

Japan's Slowing Economy Renews Calls For Expansionary Policies

The contraction in Japan's economy during the first three months of 1986 has raised doubts about the plausibility of the government's 4 percent real growth target for FY 1986 (April 1, 1986-March 31, 1987). Several research organizations have recently lowered their growth forecasts and business leaders have renewed their push for government policies to reflate the economy. But Prime Minister Yasuhiro Nakasone, while agreeing to consider a supplementary budget this fall, maintains there is no need to revise the official forecast.

Signs of continued weakness in the economy underscore the fact that the inflation-adjusted 2.1 percent decline in gross national product recorded in the first quarter of 1986 was not an aberration. The index of leading economic indicators, intended to predict future economic activity, fell sharply in April, and mining and industrial production contracted from year-earlier levels for the second straight month in May. Surveys by the research institutes of major securities companies predict an 18 percent to 24.4 percent decline in the profits of major corporations from year-earlier levels in the April-September 1986 period. Declining profits are reflected in the modest 4.5 percent wage increases won by labor this past spring, down from 5 percent last year. Thus far, summer bonuses have averaged only 1.4 percent more than 1985's.

Several research institutes have lowered their forecasts of real economic growth in the current fiscal year. Nikko Research Center sees growth falling to 2.5 percent, while the more optimistic Daiwa Securities Research Institute reduced its forecast from 3.9 percent to 3.4 percent. The latter forecast assumes another 0.5 percentage point cut in the official discount rate and a Y1.5 trillion ($8.8 billion at Y170=$1.00) supplementary budget this fall.

Business leaders, concerned by the many negative economic signals, have continued to push for stimulative policies, including a tax cut and increased government spending. Takashi Ishihara, chairman of the Japan Committee for Economic Development, called for tax changes to stimulate housing construction, which he noted has a big multiplier effect, boosting domestic demand three times the amount of the initial investment.

Although the disappointing first quarter GNP results have also increased pressure for another cut in the discount rate, Bank of Japan governor Satoshi Sumita continues to rule out such a move. The stimulative effect of the three cuts earlier this year are beginning to boost the economy, he recently said, adding that the central bank must be on guard against an increase in inflation led by fast-rising land prices. Mr. Sumita is optimistic that the economy will

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STEEL: AN EXAMPLE OF SHIFTING INTERNATIONAL COMPARATIVE ADVANTAGE

Summary

While world steel output increased six-fold in the postwar era, U.S. production actually fell. The decline of the domestic industry reflects structural changes in the U.S. economy and the substitution of lightweight materials for steel. In addition, the rapid rise of imports, which captured 25.2 percent of the market in 1985, indicates a loss of U.S. competitiveness. Protected by a series of import restrictions since 1968, the U.S. industry allowed spiraling labor costs and low rates of investment to raise its costs above those of foreign producers. But while problems plague large integrated steel producers, the outlook for mini mills appears bright.

Japan is now the largest producer of steel in the free world. Steel remains an important component of its economy, accounting for about 7 percent of output and exports. Its steel industry appears threatened, however, by increasing output in developing countries, led by Korea, Brazil, Taiwan, Argentina, Mexico and Venezuela. Although it remains the world's largest steel exporter, Japan's shipments have declined since 1976, a harbinger of the future as steel production in the developing countries expands.

Overview of Trends in Major Steel-Producing Countries

United States - At the end of World War II the United States was the world's dominant steel producer, accounting for over half of global output.

Note: All quantity figures used in this report are stated in terms of net tons.

From 88.6 million tons in 1948, raw steel production climbed to 112.7 million tons in 1957 and peaked at 150.8 million tons in 1973, although the U.S. share of world production fell as other advanced countries recovered from the war (see Table 1).

Table 1: Steel Output in the United States, Japan and Korea

(in millions of net tons of raw steel)

	United States		Japan		Korea	
Year	Output	Percent of Free World Total	Output	Percent of Free World Total	Output	Percent of Free World Total
1957	112.7	46.6%	13.8	5.7%	0.0	0.0%
1958	85.3	40.6	13.3	6.3	0.0	0.0
1959	93.4	39.8	18.3	7.8	0.0	0.0
1960	99.3	39.5	24.4	9.2	0.0	0.0
1961	98.0	35.9	31.2	11.4	0.1	0.0
1962	98.3	35.9	30.4	11.1	0.1	0.0
1963	109.3	36.9	34.7	11.7	0.2	0.1
1964	127.1	37.0	43.9	12.8	0.1	0.0
1965	131.5	36.8	45.4	12.7	0.2	0.1
1966	134.1	36.7	52.7	14.4	0.2	0.1
1967	127.2	33.3	68.5	17.9	0.4	0.1
1968	131.5	32.1	73.7	18.0	0.4	0.1
1969	141.3	31.4	90.5	20.1	0.5	0.1
1970	131.5	28.5	102.9	22.3	0.5	0.1
1971	120.4	27.7	97.6	22.4	0.5	0.1
1972	133.2	27.8	106.8	22.3	0.6	0.1
1973	150.8	27.9	131.5	24.3	1.3	0.2
1974	145.7	26.7	129.1	23.7	2.1	0.4
1975	116.6	25.0	112.8	24.1	2.2	0.5
1976	128.0	25.6	118.4	23.7	3.9	0.8
1977	125.3	25.7	112.9	23.2	4.7	1.0
1978	137.0	26.5	112.6	21.8	5.5	1.1
1979	136.3	24.8	123.2	22.4	8.4	1.5
1980	111.8	22.0	122.8	24.2	9.4	1.9
1981	120.8	24.1	112.1	22.3	11.9	2.4
1982	74.6	17.2	109.7	25.3	13.0	3.0
1983	84.6	19.1	107.1	24.1	13.1	3.0
1984	92.5	19.0	116.4	23.9	14.4	3.0

Source: American Iron and Steel Institute, Annual Statistical Report, selected issues.

Since 1970, however, the industry, particularly large integrated producers, has been in a state of quasi-permanent recession. Construction of the

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last new major steel works began in 1962. Since 1977, roughly 200 production facilities have been closed, reducing U.S. steelmaking capacity from 160 million tons to 133.6 million tons in 1985.

The problems of U.S. industry have been exacerbated by several sharp economic recessions. For example, average annual steel production from 1980 to 1984 was 9 percent below 1960-64's level and represented 20.3 percent of free world production compared with 37 percent in the earlier period. Employment in the steel industry has plunged sharply during the past two decades, with the number of hourly employees falling from a peak of 458,539 in 1965 to 291,483 in 1980 and to 170,694 in 1984. U.S. producers reported losing a total of $7.4 billion on steel operations in the 1982-85 period.

The United States became a net importer of steel mill products for the first time in 1959 when a 119-day labor strike forced domestic steel users to turn to foreign sources. From 1958 to 1980, 85 percent of the increase in imports came in the final year of labor contracts, as the threat of possible strikes prompted American industries to build up their inventories with foreign steel. Imports, attracted by U.S. prices approximately 20 percent higher than world levels, totaled 24.3 million tons in 1985 and accounted for 25.2 percent of apparent U.S. steel supply (see Table 2).

Table 2: U.S. Imports of Steel Mill Products

(in millions of net tons)

Year	Total Imports	Imports as Share of Apparent Supply	Imports from Japan	Imports from Korea
1974	16.0	13.4%	6.2	0.9
1975	12.0	13.5	5.8	0.4
1976	14.3	14.1	8.0	0.8
1977	19.3	17.8	7.8	0.8
1978	21.1	18.1	6.5	1.1
1979	17.5	15.2	6.3	1.0
1980	15.5	16.3	6.0	1.0
1981	19.9	18.9	6.2	1.2
1982	16.7	21.8	5.2	1.1
1983	17.1	20.5	4.2	1.7
1984	26.2	26.4	6.6	2.2
1985	24.3	25.2	6.0	1.9

Source: American Iron and Steel Institute, Annual Statistical Report, selected issues.

Japan is this country's largest supplier. From a 1958 level of 250,000 tons of steel, U.S. purchases of Japanese-made steel mill products expanded to 7.3 million tons in 1968. Since then, a variety of import-restrictive devices have helped limit shipments to between 4 and 8 million tons annually. Last year imports from Japan totaled 6 million tons, accounting for one-fourth of total imports and 6.2 percent of apparent U.S. supply. While imports from Japan fluctuated sharply from year to year in the first half of the 1980s, purchases from Korea increased strongly, more than doubling between 1980 and 1984 before declining last year to 8.1 percent of total imports.

U.S. steel firms have pursued a variety of strategies to improve their position, including diversification, mergers and joint ventures with foreign producers. Steel accounts for only 31 percent of the revenues of the largest producer, United States Steel Corp., which has expanded into oil, chemicals and real estate. In a move symbolic of steel's decline, it changed its name last week to USX Corp., a step many observers believe to be a prelude to selling its steel operations. LTV Corp. went the merger route, combining its Jones & Laughlin Steel Corp. with Republic Steel Corp. to form LTV Steel Co. Examples of joint ventures include the December 1985 agreement between the top U.S. producer and Korea's Pohang Iron & Steel Co. on a $300 million modernization plan for U.S. Steel's California plant and the 1984 sale of a half interest of National Steel Corp., the number-six domestic maker, to Nippon Kokan K.K.

Japan - The growth of the Japanese industry in the postwar period is unparalleled in the history of steel production. Output increased from only 1.9 million tons of raw steel in 1948 to a peak of 131.5 million tons in 1973; it surpassed the United States in 1980 and is now second only to the Soviet Union. Most of the increase occurred during the period of rapid economic growth in the 1960s.

Large steelmaking plants with huge blast furnaces employing the most efficient steel-production methods are characteristic of Japan's industry. All major plants are located on the coast with deep water ports to facilitate imports of materials used to manufacture steel and exports of the finished product. The expanding Japanese steel industry adopted the then-new "basic oxygen" process of steelmaking. Unfortunately, the U.S. steel industry was already mature before the oxygen process had fully proven its superiority. As a result, 91 percent of U.S. steel output in 1958 used the open hearth method, a technology that dated from the turn of the century, while 70 percent of the steel produced in Japan was already the product of the basic oxygen method. Moreover, Japanese firms were quick to adopt continuous casting, in which hot steel directly from the furnace is transformed into finished products, resulting in reductions of 40 to 50 percent in energy requirements, 15 to 20 percent in raw steel and 10 to 15 percent in labor requirements. Nearly 90 percent of Japanese steel in 1984 was produced using continuous casting, compared to only 40 percent in the United States.

The Japanese steel industry expanded to supply both the rapidly growing domestic economy and the expanding world market. From 1959 to 1969, the industry's period of fastest growth, world steel exports increased at an average annual rate of 9.5 percent. Japan's exports increased from only 2.5 million tons in 1960 to 17.1 million tons in 1969 (see Table 3). Although overseas shipments have declined from the 1976 peak of 39.7 million tons, they continue to account for about one-third of domestic production. In addition, other major exporting industries, such as shipbuilders and automotive makers, use large amounts of steel. It is estimated that about 60 percent of Japan's steel output is destined for export either as steel products or in the form of products containing steel.

Table 3: Exports of Steel Mill Products from the United States, Japan and Korea

(in millions of net tons)

	United States		Japan		Korea	
Year	Exports	Percent of World Total	Exports	Percent of World Total	Exports	Percent of World Total
1960	3.0	6.7%	2.5	5.6%	0.0	0.0%
1961	2.0	4.5	2.5	5.7	0.0	0.0
1962	2.0	4.2	4.3	9.0	0.0	0.0
1963	2.2	4.4	5.9	11.6	0.0	0.0
1964	3.4	5.9	7.2	12.3	0.0	0.0
1965	2.5	3.8	10.7	16.2	0.0	0.0
1966	1.7	2.6	10.5	15.8	0.0	0.0
1967	1.7	2.3	9.7	13.3	0.0	0.0
1968	2.2	2.6	14.1	16.8	0.0	0.0
1969	5.2	5.7	17.1	18.5	0.0	0.0
1970	7.1	7.1	19.4	19.5	0.1	0.1
1971	2.8	2.7	25.5	24.1	0.1	0.1
1972	2.9	2.5	23.0	20.4	0.5	0.4
1973	4.1	3.3	27.3	22.0	0.9	0.7
1974	5.8	4.0	35.5	24.6	1.3	0.9
1975	3.0	2.3	31.9	25.3	1.0	0.8
1976	2.7	1.9	39.7	28.5	1.5	1.1
1977	2.0	1.4	36.8	26.4	1.5	1.0
1978	2.4	1.6	34.0	22.3	1.8	1.2
1979	2.8	1.8	33.8	21.7	3.5	2.2
1980	4.1	2.7	32.7	21.4	5.0	3.3
1981	2.9	1.9	31.3	20.3	5.2	3.4
1982	1.8	1.3	31.6	21.6	6.1	4.2
1983	1.2	0.8	34.0	21.7	6.3	4.0

Source: International Iron and Steel Institute, Steel Statistical Yearbook, 1984.

In the 1950s steel exports were viewed as necessary to pay for the raw materials used in production. The industry continues to rely heavily on imported inputs. To produce 116 million tons of raw steel in 1985, Japan imported 137.2 million tons of iron ore (100 percent of requirements) and 69.5 million tons of coking coal (95 percent of requirements).

During the 1973-74 steel boom, Japanese companies inaugurated an expansion plan that had increased productive capacity to between 155 and 160 million tons by 1980. With slowing demand for steel at home and abroad creating excess capacity, though, producers have concentrated in recent years on installing new technology to improve efficiency, reduce costs and conserve energy. From 1973 to 1982, energy consumption per unit of raw steel declined 16 percent and the share of oil in total energy used fell from 20 percent to 7 percent.

Despite its success, the Japanese steel industry faces a period of uncertainty both in the short run and over the long term. Japan's share of world steel exports fell from 28.5 percent in 1976 to 21.7 percent in 1983 and is thought to have slipped again in 1984 and 1985, in part because of constraints on shipments to China and the United States, which have accounted for nearly half of exports in recent years. Neither country is likely to provide an expanding market in the near future; shipments to China are limited by its lack of foreign exchange, and exports to the United States are capped under a voluntary restraint arrangement that runs through 1989. Moreover, the appreciation of the yen will worsen Japan's competitive position relative to developing-country producers, which account for an increasing share of world steel trade. With profits of the six major Japanese steelmakers already down between 12 percent and 25.3 percent in FY 1985 and expected to fall more in the current fiscal year, capital expenditures are projected to decline in FY 1986 for the third consecutive year.

In addition to cost-cutting measures, Japanese steel companies are attempting to stay profitable through diversification and overseas investment. At Kawasaki Steel Corp., the number-three producer, steel accounted for 85 percent of the firm's net sales in the April 1985-March 1986 period, while 4 percent came from chemicals and 11 percent from engineering services and other activities. By the year 2000 Kawasaki expects steel to account for only 60 percent of net sales, with other products and services, such as carbon fibers, ceramics and data communications, accounting for the remainder. In addition, Kawasaki has invested in overseas facilities, including a steel slab plant in Brazil and a rolling mill in Fontana, California.

Korea - While output and capacity have been shrinking throughout the industrialized world, developing countries have expanded their steelmaking capacity significantly. Korea, whose steel output increased from less than a million tons in 1972 to 14.4 million tons in 1984, is an important new producer. Its exports have also increased rapidly, reaching 6.3 million tons in 1983. Unlike producers in developed countries, Korean firms have ambitious plans to increase their steelmaking operations.

Korea's Pohang facility is generally acknowledged as the world's most efficient steel plant. Built with Japanese technology, it has a capacity of 9 million tons. The industry benefits from low labor costs of about $3 an hour, compared to $20 in the United States. But like Japan, Korean firms rely on imports for nearly all of the iron ore and coking coal used in steel production.

What Caused the Decline in the U.S. Industry?

The deline of this country's steel industry has been blamed on a variety of factors, including low rates of investment, high labor costs, import protection and structural changes in the economy. Each of these factors will be explored in the following sections.

Low Rates of Investment - Expenditures on plant and equipment in the 1970s were no higher than in the 1950s and substantially less than in the 1960s. As a result, the real net productive capital stock in 1980 was about 14 percent below 1974's. Investment was discouraged by a decline in the rate of return on capital, which averaged less than half the rate in all manufacturing from 1958 to 1983. This reduced the amount of investment money that could be generated internally, forcing a growing reliance on external financing and increasing the proportion of funds devoted to repayment of long-term debt.

The low rate of investment combined with an emphasis on pollution control led to an increase in the age of steel's capital stock, indicating technological backwardness. During the 1970s, the vintage of the plant stock aged 4.5 years and reached nearly 19 years in 1980, compared to a manufacturing average of about 15 years. In addition, the average age of the steel industry's productive equipment rose over one year to 8.7 years, compared to about 7 years for the manufacturing sector.

A related factor has been the industry's slow adoption of technological innovations, such as basic oxygen furnaces and continuous casting. As mentioned above, these technologies enabled makers abroad to lower the costs of inputs, including energy, despite major price increases in the 1970s. The financial difficulty of many U.S. producers made it difficult for them to invest in new production methods. And firms with capital to invest were often attracted to the higher returns available in other areas, such as oil.

Spiraling Labor Costs - An 11 percent average annual increase in compensation in the face of declining labor productivity doubled unit labor costs in the United States between 1974 and 1980. Steel workers' wage gains exceeded the 9.2 percent annual growth in other industries, hitting $17.01 per hour compared to $9.28 for all manufacturing. The 80 percent wage premium paid to steelworkers in 1980 was all the more surprising in view of the fact that steel workers have a lower-than-average level of technical expertise.

Steel industry wages began rising rapidly in 1971, following the dollar devaluation and the implementation of voluntary steel export restraint agreements. Management's desire to end the threat of strikes, which encouraged large jumps in imports every three years, led to the Experimental Negotiating Agreement in 1973. This arrangement allowed large wage increases by guaranteeing production workers 3 percent annual wage increases, cost of living adjustments and productivity bonuses in exchange for a no-strike pledge. Although union concessions have lowered hourly compensation from its 1982 peak of $23.78, U.S. labor costs remain far higher than those of other countries. In 1983, American labor costs per ton of steel were $154 compared to $104 in Japan and $22 in Korea.

Import Protection - Washington set out to protect the domestic steel industry in 1968 when imports reached 17 percent of domestic consumption. Japan and the European Community agreed to three-year VRAs that limited their U.S.-bound exports of steel mill products to 4.75 million tons each. A second, more comprehensive set of restraint arrangements was then negotiated covering the period through 1974. Following the 1975 recession, imports rose to 18 percent of the U.S. market in 1977. As an alternative to the numerous dumping cases filed by the industry, President Carter established the trigger price mechanism, which was designed to prevent foreign firms from selling steel below a price based on Japanese production costs. This was replaced in 1982 by a three-year agreement between the United States and the EC limiting European exports to this country.

In the summer of 1984 the International Trade Commission ruled that imports of semi-finished products, plates, sheets and strip, wire and wire products and structural shapes had injured the domestic steel industry and recommended a complex package of quotas, extra duties and tariff quotas for five years. President Reagan instead opted to negotiate five-year VRAs with 17 countries (in addition to the EC) in hopes of limiting imports to about 20 percent of domestic consumption. As a result, more than four-fifths of U.S. steel imports are covered by bilateral agreements. Many legislators from steel-making states, however, are dissatisfied with the results of the program thus far. Legislative remedies, including a 20 percent tariff and quotas limiting imports to 15 percent of the U.S. market, have been introduced in Congress.

During the past 18 years, the domestic industry has argued for import restraints to give it a "breathing spell" in which to regain international competitiveness. But almost continuous protection from foreign producers has actually worsened the competitive position of the U.S. industry by removing the incentive to make difficult adjustments. Table 4 shows compensation, productivity and investment in the steel industry compared to all manufacturing during the period of import restraints (1968-80) and during the prior decade (1958-68). During the period without import restrictions, the steel industry closely matched other industries in all three categories. But during the period of protection, steel's performance was substantially worse: compensation grew more than twice as fast while productivity advanced only one-fourth as fast, and investment declined. The consequence of protection, therefore, was a less competitive U.S. industry. In addition, the higher steel prices resulting from protection worsened the competitive position of U.S. steel-using industries.

Table 4: Effects of Protection on the U.S. Steel Industry

(annual growth rates)

	Without Protection (1958-68)	With Protection (1968-80)
Real Compensation*		
All Manufacturing	4.10%	8.01%
Steel	4.00	10.37
Productivity		
All Manufacturing	3.18	2.25
Steel	3.30	0.85
Gross Investment**		
All Manufacturing	7.51	3.91
Steel	6.68	-2.85

*Wages for production workers adjusted for inflation using the consumer price index.
**Excluding pollution-abatement equipment.

Source: U.S. Department of Commerce, Office of Business Analysis.

Structural Changes in the U.S. Economy - U.S. steel consumption has followed a downward trend since peaking at 122.5 million tons in 1973. The 98.9 million tons of steel consumed in 1984 were below 1965's level (see Table 5). This decline, despite a 76 percent rise in real GNP during the period, indicates a substantial drop in the importance of steel in the U.S. economy. The ratio of steel consumption per million dollars of GNP declined from 132 tons in 1950 to 108.2 tons in 1965 and 60.3 in 1984. It should be noted, though, there has been a sharp increase in imports of steel-intensive products, such as cars.

Table 5: Steel Consumption in the U.S. Economy

Year	Real GNP (billions of 1972 dollars)	Consumption (thousands of net tons)	Ratio of Steel Consumption to GNP*
1950	$534.8	70,607	132.0
1955	657.5	81,629	124.2
1960	737.2	71,531	97.0
1965	929.3	100,553	108.2
1970	1,085.6	97,100	89.5
1975	1,231.6	89,016	72.3
1980	1,475.0	95,247	64.6
1984	1,639.3	98,922	60.3

*Net tons per million dollars of GNP.

Source: American Iron and Steel Institute, Annual Statistical Report, selected issues.

Such a decline is not unique to this country; once a nation has built its industrial infrastructure, demand for steel levels off. For example, investment in non-residential structures as a share of GNP fell from 4.9 percent in 1966 to 3.7 percent in 1976 before recovering to 4.3 percent in 1984. In addition, as incomes rise, consumers tend both to demand products that have a lower steel content and to consume more services. Services now account for about half of GNP.

In addition to changes in the composition of GNP, a second cause of the decline in steel intensity has been the substitution of lightweight, energy-efficient materials, such as plastics and aluminum. Rising energy costs, for example, prompted auto makers to reduce the amount of steel by about 400 pounds per vehicle between 1978 and 1984.

Rising Importance of Mini Mills - The decline of the U.S. steel industry reflects the weakening of its integrated segment. In these plants, iron ore, coke and limestone are combined in a series of processes to make raw steel and finished products. The industry's mini mill segment, in contrast, has experienced strong growth, capturing markets from both domestic integrated steelmakers and foreign producers. Mini mills are generally smaller plants with electric furnaces that transform scrap metal into finished products such as wire, light structural shapes, and pipes and tubes.

Mini mills' share of U.S. steel output increased from 3 percent in 1960 to 20 percent in 1984. With advances in technology, they are expected to capture 40 percent of the market by the end of the century. These mills employ more advanced technology, including continuous casting, to minimize input costs, and their electric furnaces require only one-third as much energy. Taking advantage of their smaller size, they have located in urban areas close to their product and material markets, thus saving on shipping costs. Moreover, mini mills, which generally employ non-union workers, enjoy substantially lower labor costs and have avoided the adversarial labor-management relations that characterize integrated mills. The leading U.S. mini mill producer, Nucor Corp., has a labor cost of about $55 a ton, compared to $140 a ton for integrated producers.

The Outlook For Japan's Steel Industry

Per-capita steel consumption in most industrialized countries is currently between 500 and 600 kilograms of crude steel, compared to a world average of about 165 kilograms. There is therefore likely to be substantial growth in steel demand in developing regions as incomes rise. Most of the growth in steel production is also likely to take place in less developed countries, aided by government subsidies and other assistance. While output in most industrialized countries has stagnated or even declined during the past 10 years, production in developing countries doubled during the 1974-83 period to 69.7 million tons. Much of the increase took place in Asia, an important market for Japanese producers, accounting for nearly three-fifths of total exports in 1985.

This expansion has reduced the third world's reliance on steel shipments from industrialized nations. In the mid-1970s, imports supplied these areas with more than half of their requirements. But net imports fell from 40.2 million tons in 1981 to 25.2 million tons in 1983, while consumption rose to about 100 million tons. Moreover, the developing countries accounted for 12.4 percent of global steel exports in 1983.

These trends pose an interesting challenge to the future of Japan's steel industry, the world's largest exporter. One issue is whether Japanese producers will be able to maintain their share of the world steel market. A second question is whether imports, which accounted for less than 5 percent of apparent consumption last year, will make significant inroads into Japan's domestic market. With the sharp appreciation of the yen during the past year, imports are certain to increase their market penetration in many industries. The diversification of Japanese producers into non-steel engineering materials, such as ceramics, chemicals and superalloys, as well as other areas, including computers and semiconductors, suggests that they are not entirely confident of their future in steel.

Thus far Japanese producers appear to have successfully avoided the mistakes that made U.S. producers uncompetitive. According to Mitsui & Co., Ltd., Japanese firms invested $19.6 billion in steel from 1979 to 1984, compared to $12.8 billion in the United States. The major mills continue to innovate, producing new products such as sea-water resistant steel for oilwell piping and high-strength steel for nuclear power plants. The number of production workers has been reduced by about 16,000 to 181,592 in 1985 and labor costs have remained moderate. Wages increases amounted to only 7 percent in inflation-adjusted terms from 1980 to 1985. In contrast to the 4.5 percent average wage hike in this year's spring wage negotiations, steel workers received increases of only 2.7 percent, their smallest ever, and several major firms have frozen executives' wages.

But as in the United States, structural changes in the domestic economy are working against Japan's steel industry. Steel consumption per capita in Japan has fallen from 714 kilograms in 1974 to 548 kilograms in 1983 (see Table 6). In Korea, however, the opposite is true, with per-capita consumption rising from 93 kilograms to 223 kilograms during the same period. Although per-capita consumption in Japan is still 2.5 times greater than in Korea, it is likely that demand will increase rapidly in the future in Korea, while stagnating or even declining in Japan.

Table 6: Per-Capita Steel Consumption

(kilograms of crude steel)

Year	United States	Japan	Korea
1974	680	714	93
1975	547	608	84
1976	604	577	110
1977	618	554	182
1978	672	579	180
1979	640	673	183
1980	508	675	160
1981	565	603	193
1982	363	586	194
1983	404	548	223

Source: International Iron and Steel Institute, Steel Statistical Yearbook, 1984.

Conclusion

The global steel industry in the postwar era has experienced rapid changes in comparative advantage. Steel production in the 1950s was dominated by the advanced nations, particularly the United States, but now this country imports steel from numerous developing countries. Imports have increased their share of the U.S. market from less than 5 percent in 1961 to 25.2 percent last year.

The worldwide shift in comparative advantage threatens Japan's role as the free world's largest and most efficient steel producer. In particular, Korea poses a major challenge. Chase Econometrics estimates that Japanese steelmaking capacity will decline 18 percent to 129 million tons by 1995, while Korea adds 14 million tons of capacity. As Korea's steel industry expands, it will build plants incorporating the latest technology and will enjoy greater economies of scale. It appears inevitable, therefore, that Japan will lose world market share. Moreover, to maintain their international competitiveness, Japan's automotive makers and other big steel-using industries must have access to the most inexpensive steel. For this reason, it is likely that Japanese steel imports will also increase.

For further information, contact Randall S. Jones.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

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JEI

REPORT

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Japan Holds Firm On Interest Rates

Tokyo continues to resist domestic and international pressure to lower its interest rates despite the July 11 cut in the Federal Reserve Board's discount rate. Bank of Japan governor Satoshi Sumita noted that Japan's rate, which has been cut three times this year, is the lowest of the industrialized nations (along with West Germany) at 3.5 percent. He added that Japan's economy requires no additional monetary stimulus at present, even though the economy contracted in the first three months of the year.

this increase would certainly bring total defense spending well above one percent of the nation's gross national product but would also insure that the current five-year procurement program remains on tr[illegible] In yen terms, the increase would amount to Y250.5 billion ($1.6 billion at [illegible]0=$1.00), bringing total defense spending to about Y3,590.5 billion ($22.4 billion).

The report comes only days after Prime Minister Yasuhiro Nakasone's convincing win at the polls. Although the prime minister has reiterated his intentions to maintain present austerity policies, defense and foreign aid have been two significant exceptions to this rule. With a solid 300-plus seat Liberal Democratic Party majority in the lower house -- the more important of the two chambers in the Diet -- there is no reason to expect a policy change in the coming year. The only questions are the degree of the expected hike in JDA's budget and how that increase will be allocated among competing programs.

The current press reports appear to be the first round in a series of leaks consciously planted by JDA and Ministry of Finance officials in an effort to influence the budget for the next fiscal year. As a rule, the press reports somewhat later that a significantly lower figure has been "approved" by MOF. The prime minister has played an important personal role in influencing the final outcome of these negotiations, usually favoring the JDA position. All this is part of the Japanese budgetary process, which specifies that government agencies must submit preliminary requests by the end of July, with MOF establishing budgetary ceilings -- preliminary figures setting maximum budget increases for the coming fiscal year -- in the early fall.

In addition, JDA will face important decisions on new projects, including upgrading its P-3 anti-submarine planes and deciding on the FSX fighter support aircraft. The latter is perhaps one of the most controversial issues facing the agency in recent years. It has been suggested that instead of buying or co-producing an American jet -- the F-18 and F-16 were mentioned as prominent candidates -- JDA would opt for utilizing design and technological inputs of the F-18 as the basis for developing an essentially domestic hybrid. The reports suggest that McDonnell Douglas Corp. -- the developer and manufacturer of the F-18 -- would be involved in the project and that the engines for the fighter would also come from U.S. sources.

If the 7.5 percent raise is approved, it would be the highest increase in recent years for JDA. That figure, however, probably tops JDA's wish list and is not its essential level for FY 1987. Nevertheless, given the combination of tight budgets and slow economic growth in Japan, any increase will be heatedly debated.

Michael W. Chinworth

Databases, Information Industry Expanding Rapidly In Japan

According to several government and semi-governmental organizations, Japan is making rapid progress toward its goal of becoming an "information society" by the turn of the century. The office automation revolution is beginning to play a significant role in Japan's total output of goods and services. At the same time, computerization of homes and offices has created a whole new demand for databases and related services that is just beginning to be addressed by the market.

The Economic Planning Agency issued estimates in early July on the size of the nation's information industry. Defined as the production, processing and accumulation of information and similar activities, the information industry includes sales of database services, software and software services, and all costs incurred by corporations in obtaining those services. Excluded are sales of computers and telecommunications equipment to households and public organizations except for the postal service. EPA calculates that Y30.2 trillion ($188.8 billion at Y160=$1.00) of Japan's gross national product fell under this definition during fiscal 1984 (ended March 31, 1985), equal to 10 percent of total GNP. The value of information production came to over Y3 trillion ($18.8 billion) for the fiscal year, more than triple its level seven years before. The information industry's penetration of the economy is revealed by the fact that only 38 percent of sales in FY 1984 came from companies specializing in such services, far below the 72 percent share they held in FY 1977. And EPA estimates that 9.4 percent of FY 1984's labor force was employed by the industry, or approximately 4 million persons, far above FY 1977's 800,000 level.

Database services, in particular, have been expanding at a 25 percent annual rate for the past several years, says the Database Promotion Center, a semi-public organization under the aegis of the Ministry of International Trade and Industry. The DPC's June 24 white paper states that the database market accounted for only 7 percent of fiscal 1985's total information industry sales, a surprisingly small sum. Only 110 database companies operate in Japan, lamented the report, compared with 1,700 in the United States. Of the nearly 900 databases available in Japan in FY 1985, only approximately 20 percent were of domestic origin. Finally, the DPC reports that 24,000 Japanese were database users, a paltry number compared to the estimated 400,000 U.S. users.

Slightly different figures were compiled May 20 by a MITI agency that released the country's first database register, showing steady growth in the number of databases and database firms (see Tables 1 and 2). An analysis of registered databases by topic shows that science and business-related information collections account for nearly half of the total number (see Table 3). Evidence of the importance of external markets to Japan is indicated by the fact that databases on foreign economic conditions and companies outnumber the domestic counterparts by between two- and four-to-one.

While the numbers are different, the two reports agree on some important points: the industry has shown significant growth over the past few years; and growth of available databases has been dominated by foreign providers. Japan certainly lagged behind the United States in the formation of databases, and it is encouraging to observe that foreign information services are being freely exported to Japan. It will be interesting to see whether foreigners will maintain this lead in coming years. It would certainly be lucrative: the EPA estimates that the entire information industry will quadruple in value by the year 2000.

Jon Choy

Table 1: Databases in Japan, FY 1982-FY 1985

(number and percent)

	Foreign		Domestic		
	Number	Share	Number	Share	Total
FY 1982					
Registered	472	78.1%	132	21.9%	604
Actual	334	73.2	122	26.8	456
FY 1983					
Registered	743	81.1	173	18.9	916
Actual	522	76.9	157	23.1	679
FY 1984					
Registered	1,034	83.3	208	16.7	1,242
Actual	725	78.5	199	21.5	924
FY 1985					
Registered	1,401	82.3	301	17.7	1,702
Actual	1,008	78.2	281	21.8	1,289

Note: "Actual" figures reflect the elimination of double counting.

Source: Ministry of International Trade and Industry

Table 2: Japan's Database Industry, FY 1982-FY 1985

(number of companies)

	Primary Business	Secondary Business	Total
Database Producers			
FY 1982	6	24	30
FY 1983	8	29	37
FY 1984	13	42	55
FY 1985	21	52	73
Database Distributors			
FY 1982	17	30	47
FY 1983	22	29	51
FY 1984	24	48	72
FY 1985	32	58	90
Database Research Firms			
FY 1982	3	10	13
FY 1983	3	10	13
FY 1984	4	20	24
FY 1985	9	19	28

Source: Ministry of International Trade and Industry

Table 3: Japanese Databases by Topic, FY 1984-FY 1985

(number of registered databases)

	1984	1985
General databases		
General information	39	65
News	46	68
Biographical, company data	27	43
Management	34	34
Law	20	32
Politics	12	14
Other	3	12
Subtotal	181	268
Natural sciences, technology		
General information	38	57
Life sciences*	91	130
Chemistry	82	109
Physics, electronics, computers	52	61
Patents	38	59
Industrial, mechanical	23	32
Space, geophysics, oceanography	27	30
Environment	23	26
Energy	15	24
Agriculture	13	17
Meteorology	12	14
Metallurgy	12	12
Food	10	11
Textiles	--	8
Mathematics	--	6
Other	23	39
Subtotal	459	635
Social science, culture		
General information	9	13
Library science	35	41
Education	26	24
Sociology	10	11
Population statistics	7	8
History	7	7
Art	--	7
Psychology	6	6
Linguistics	5	6
Other	12	16
Subtotal	117	139

	1984	1985
Business		
General information	20	47
Market, product data	101	109
Foreign economic data	89	105
Domestic economic data	21	21
Foreign corporate data	59	90
Domestic corporate data	33	43
Stock and bond quotations, exchange rates	70	80
Energy	27	28
Telecommunications, transportation	--	23
Agriculture	12	15
Chemistry	7	12
Labor	8	8
Architecture, construction	--	7
Other	19	42
Subtotal	466	630
Miscellaneous		
Dictionary, glossary	8	12
Maps, charts, addresses	5	7
Other	6	11
Subtotal	19	30
Total	1,242	1,702

*Such as biology, anatomy, pharmacology and veterinary science.

Source: Ministry of International Trade and Industry

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REPORT

NO. 27A

July 25, 1986

THE JAPANESE ELECTIONS: THIRTY MORE YEARS?

Summary

The ruling Liberal Democratic Party celebrated its thirtieth anniversary by scoring one of its most impressive victories at the polls July 6, winning 300 of the influential lower house's 512 seats. With the addition of several independents, the LDP commands a 304-seat majority in the lower house, its strongest position in the postwar era.

Senior LDP leaders, especially Prime Minister Yasuhiro Nakasone, are now jockeying to utilize that power to further personal and party political agendas. Japan's allies, particularly the United States, apparently feel that the way has been cleared for prompt resolution of outstanding trade issues as well. Yet the large margin of victory in some respects will complicate rather than alleviate political pressures in Japan. For although the LDP has managed to reduce the influence of opposition parties, powerful factions within the party -- the more important element in domestic politics -- remain, posing considerable problems for the prime minister and his supporters.

The Double Election

Although last-minute election surveys pointed to the potential for an election landslide, most political observers in Japan did not anticipate the overwhelming LDP victory in July's double elections. Indeed, before the campaign, Mr. Nakasone said that a simple majority of 256 seats in the lower house would constitute a victory. Since he was pinning his hopes of a third term as party president on a favorable performance, his rivals tried to pressure the incumbent by suggesting that anything less than a 270-plus seat victory would be disaster for the party and would warrant Mr. Nakasone's resignation.

Were they surprised! Voters gave the LDP a commanding 300-seat majority in the lower house and 140 of 250 seats in the upper house, the less important of the two -- confirming the prime minister's decision to encourage a high turnout by calling the double elections. High voter turnout traditionally benefits the LDP by bringing marginal party supporters to the ballot boxes. Although voter turnout was not as high as in some elections, it nevertheless exceeded 70 percent, an increase -- especially of independents and less consistent LDP voters -- that was critical to victory.

In 1983's disastrous elections, the LDP received 45.8 percent of the votes cast, reducing the party's representation in the lower house from 286 to 250. In the most recent balloting, the LDP took only 49.5 percent of the vote, but the extra 3.7 percentage points coupled with efficient distribution of party endorsements resulted in a gain of 50 seats. Increased support among independent voters may have been particularly significant, jumping from 1983's level of 48 percent to 60 percent in the July balloting. Significantly, the LDP gain came primarily at the expense of the Japan Socialist Party.

This suggests several factors that moderate the dimensions of the LDP's victory. First, although no single opposition party was able to muster impressive numbers at the polls, it is nevertheless statistically true that the LDP was unable to gather a majority of voters in the lower house balloting. The addition of so many seats on the basis of such a marginal increase in voter support makes it clear that the party's strength is still dependent on gerrymandered, multi-member election districts. Rural areas -- the source of much of the LDP's strength -- remain disproportionately represented vis-a-vis urban centers. While there are indications that the LDP may be picking up some urban seats and benefiting from favorable political demographic changes, the party remains tied to the rural and semi-rural areas for support.

Equally important is the fact that the LDP was far better prepared for the election and distributed its resources more efficiently than the opposition parties. In reconstructing the process, it will be rememberd that one of the final actions taken in the last regular Diet session was approval of an electoral reform bill that shifted a handful of seats from over-represented rural districts to under-represented urban areas. The bill also prohibited lower house elections within 30 days of enactment, a provision considered essential to secure passage. Many observers felt at the time that this rider would prevent the prime minister from holding double elections in June, a contingency for which the ruling and opposition parties had been preparing. While the opposition may have been misled on this point, the LDP was not. Election preparations that had been put in motion in April continued at a rapid pace, so that the party was in a favorable position when the prime minister made his move: he convened a special session of the Diet, subsequently dissolved it and set the stage for double elections at a slightly later date than originally anticipated.

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The maneuver was blasted by the opposition parties, which may have been caught unprepared for the balloting. The largest opposition group, the Japan Socialist Party, has been in transition from a doctrinaire socialism to a more moderate stance -- a process that has generated considerable strife within the party. The JSP would have preferred more time to reach a satisfactory consensus and repair its fragile unity. It was certainly at a disadvantage having to face the voters in its weakened state.

Other minor opposition parties promised to form a united front in certain election districts, but cross-party cooperation was virtually nonexistent -- a sharp contrast with the LDP's well-disciplined image of a party with 30 years of leadership. Thus, while popular support for opposition parties collectively remains high, no single party has been able to present a coherent, credible alternative to LDP leadership and back it up with sufficient resources to assure concrete gains in Diet seats. This is especially critical for the JSP, a big loser July 6.

The LDP's command of the situation was demonstrated by the fact that officially endorsed candidates won 94 percent of their races. Despite the objections of certain factions, the LDP endorsed only 320 candidates -- far lower than the number fielded in 1983 -- so as not to dilute party votes in multi-member districts. The party felt its loss of 50 seats then was attributable in part to the large number of endorsed candidates. The LDP won more than 200 seats in its "safe" districts and added another 90 or so in the more heavily contested areas.

The timing was also favorable for the LDP. The lower house was not due to be dissolved until December 1987. However, several factors favored holding elections immediately. The first was that party coffers were brimming from two years of heavy contributions, while the opposition parties were not so financially fortunate. Second, the popularity of the prime minister and the cabinet as a whole was incredibly high. The prime minister registered support levels in excess of 50 percent, according to most major polls. (In recent years, the prime minister's support among the electorate has fallen below 20 percent within a year.) Cabinet approval ratings were similarly high and steady -- around 40-plus percent going into the elections. By taking advantage of these support levels now, election proponents argued, they had a prime opportunity to strengthen the LDP's hold on the government. To the chagrin of the prime minister's opponents, this plan fit perfectly into Mr. Nakasone's grand strategy to secure a virtual public mandate for continued leadership, but it also served the needs of the party.

What final impetus was needed appeared in the form of weak economic forecasts. Moreover, conditions threatened to worsen in the fall and many officials felt it would be better to go to the polls before that came to pass than waiting until the country was caught in the middle of a full-fledged recession. Political analysts say that in times of uncertainty, Japanese voters will go with a proven commodity rather than experiment with unknowns; obviously, that means the LDP.

Election Impact: Policies

Prime Minister Nakasone was jubilant when the election results were in. In 1983 the balloting was held against his personal wishes but in keeping with the desires of former prime minister and Nakasone-supporter Kakuei Tanaka. Yet Mr. Nakasone was held personally accountable for the horrendous results, and political pundits generally agreed that his short career was at an end. Repeated maneuvering, however, enabled him not only to retain power but also to set the stage for a possible third term as party president, currently prohibited by LDP rules. His complex scenario for achieving a third term included getting his legislative agenda through the lower house -- despite the LDP's very tenuous hold on the chamber, hosting the economic summit in Tokyo and holding double elections that would return the party to undisputed power.

For a while, it all seemed like pie in the sky. The Diet proved reluctant to tackle many controversial issues, particularly in the later stages of the regular session. The summit had to be written off as a personal disaster for the host. And chances for holding double elections appeared to be preempted by the electoral reform bill's restriction on election dates. Political polls, while reflecting continued high public support for Mr. Nakasone, also suggested the appearance of chinks in his personal armor. The economy was beginning to feel the effects of the strengthened yen and economic forecasts were revised downward, making many LDP members fearful of facing the voters. Finally, encouraged by the negative turn of events for the incumbent, Mr. Nakasone's rivals had come out in the open in their efforts to wrestle control of the party presidency from his hands.

The picture was different after the votes were counted. Mr. Nakasone, who had made the election a referendum on his policies and leadership style, called the results "a voice of the gods." Since Mr. Nakasone had insisted that the election was a reflection of his leadership, the implication was that the voters favored his remaining in office and supported his policies, including such issues as administrative reform, and stylistic elements, like his controversial visits to the Yasukuni Shrine for Japan's war dead. Editorial writers, particularly those opposed to the Nakasone policies, warned the LDP and the premier against growing arrogant as a result of the election. Some went so far as to suggest that Japan could return to its pre-war nationalism if Mr. Nakasone misread the voters' mood and interpreted the election results as a carte blanche endorsement of his leadership.

Yet the LDP and Mr. Nakasone are clearly in a superior position to pursue their policies and personal ambitions. With the opposition parties reduced to a minor consideration in Diet wheeling and dealing, the LDP should be able to move ahead in areas where it has been stalled. This includes privatization of the Japanese National Railways; approval of emergency measures that would reduce or eliminate impediments to the mobilization of the Self-Defense Forces in the event of national emergencies; and enactment of controversial anti-espionage legislation -- a high priority item in certain LDP and government circles that has been held up because of opposition party objections.

The general pro-defense stand of the government is certain to continue, although it is not necessarily contingent on Mr. Nakasone's remaining in office. Bureaucratic momentum generally favors the present course on defense. For example, giving the Japan Defense Agency's five-year plans the status of official government programs (instead of planning documents) has lent considerable weight to present policies. Nevertheless, it is likely that the pace would be accelerated under a Nakasone government, while his potential successors might favor other goals -- a tighter budget at the expense of increased defense spending or increased aid, for example. With Japan's economic growth slowing, there is a high probability that the one percent debate will grow hotter in the near future. Of all those in line for power, Mr. Nakasone would be the most likely to use the opportunity to break that longstanding barrier and discard the policy altogether. Still, it would be unwise to suggest that the election results are a blanket endorsement of the Nakasone defense policies, any more than to assume that 1983's losses reflected a negative judgment.

Still, there is a widespread assumption in the United States that the "Nakasone victory" will result in a prompt and -- from the U.S. perspective -- favorable response on proposals that Japan participate in the Strategic Defense Initiative. Indeed, the prime minister can be expected to push for a positive response, but the political horsetrading that will occur in the coming weeks will further delay a decision that already has been postponed several times due to both political and policy considerations. The SDI issue is highly controversial in Japan, and doubters of the program abound in the government. Siding with SDI has considerable implications for Japan's security policies. Although the odds are still in favor of Japanese participation in some form, a decision will not be reached simply because of the July election results.

One area in which faster action cannot be expected is in implementing the recommendations of the Maekawa commission to restructure the domestic economy. The election results do give more substance to the prime minister's endorsement of the report earlier this year and offer him some leverage over its opponents. However, the most important source of resistance to the recommendations has not come from opposition parties, but from big business, a key backer of the Liberal Democratic Party, which has expressed doubts about the kinds of policies that would appear to be necessary to fulfill the aims of the Maekawa group. Furthermore, the reforms are so fundamental that the government will be very methodical about implementation. Immediate political priorities may be adjusted instead to reflect the primary goals of many business organizations -- tax and administrative reform -- to stimulate domestic economic growth. The chances of the anticipated Y3 trillion ($18.8 billion at Y160= $1.00) supplementary budget being approved, however, have been enhanced as a result of the elections.

The Election's Impact: Mr. Nakasone's Future

Rival faction leaders conceded that if the LDP secured 280 or more seats -- an optimistic target at the time -- there might be some justification for modifying party rules to allow a third term for Mr. Nakasone as president. Thus, the final results put the incumbent in a position to claim continued leadership of the party. His case is simple and convincing: no party leader has ever produced such a victory at the polls in the LDP's 30-year history (although it has drawn higher percentages of voters in the past). Potential successors have to deal with an unpleasant reality: what has been good for the party as a whole has also been good for Mr. Nakasone.

Although insisting he will "abide by party rules," most observers feel that Mr. Nakasone will seek a third term as party president. Once an uphill struggle, the chances are now at least 50-50. Already there is speculation that Mr. Nakasone will make a deal with Noboru Takeshita, leader of the party's largest faction, that will enable him to remain in office for at least one year while Mr. Takeshita secures his hold on the LDP and his own faction as party secretary general. (Foreign Minister Shintaro Abe reportedly seeks a party post as well for the same reason.) That scenario appears credible. In any event, it is clear that a Nakasone-Takeshita coalition has been developing over the past several months in recognition of the fact that without mutual support, neither will be able to achieve his personal ambitions.

Mr. Nakasone faces two problems. First, despite the impressive party-wide performance in the elections and the fact that his personal faction made sizable gains as a result, the Nakasone faction remains at best -- depending on who's counting -- the third largest in the party. His leverage has been increased because of the party's victory, but his weight within the party still remains limited by the relatively small size of his faction. Second, even with the support of the Takeshita faction, which appears to consist primarily of the former Tanaka faction plus new additions, at least one other faction's votes will be required to change party rules at the fall convention to produce a two-thirds majority. The best candidate at this point seems to be the Suzuki faction, which has supported the Nakasone government in return for key cabinet and party positions. The incentives for cooperation remain strong because the faction's own candidate for the presidency -- LDP executive council chairman Kiichi Miyazawa -- is said to have damaged his credibility by objecting to the double elections until the final moments.

Assuming a Nakasone-Takeshita-Suzuki alliance, any number of possibilities exist for the fall, including the elimination of restrictions on the number of terms for the party president, a one- or two-year extension for Mr. Nakasone, or even electing Mr. Takeshita party president while retaining Mr. Nakasone as prime minister. In any event, major factions will jockey for position in the weeks to come to strengthen their positions and resolve the issues before they threaten to damage the gains won in the elections.

Several loose ends must also be resolved in this bargaining. The first are the roles of senior LDP officials, including Shin Kanemaru, the present secretary general, and party vice president Susumu Nikaido. It is highly possible that Mr. Nikaido -- once Mr. Tanaka's political right arm -- will be phased out of power. His personal ambitions at times have appeared to exceed his functional role as an honest broker -- an essential element in inter-factional negotiations. As for Mr. Kanemaru, many of his moves have ruffled a few feathers in the party. He decided, for instance, to limit the number of party endorsements in the election even though it came at the expense of a particular faction. But he has been a principal in decisions that proved beneficial to the party as a whole.

If the prime minister remains in power, it is likely that he will continue his general policy theme of "settling the postwar accounts." This could only prove controversial if the election results embolden him to abandon his previous restraint. Educational reform will remain a top priority, although the heated debate often resurrects visions of the war years and could involve an element of risk. It cannot be denied, however, that the prime minister has a certain amount of leeway in future policies.

Relations with the United States

Although officially the Reagan administration might insist that it is not appropriate for a foreign government to side with a candidate of another country, the election results were encouraging to the United States if only because they mean four years of relative political stability in Japan, thus simplifying the conduct of bilateral relations. This is especially true if Mr. Nakasone remains in office. The continuation of a unique personal relationship between the leaders of both countries has contributed to remarkably stable relations despite an abundance of highly contentious issues.

One theme in the American press coverage of the Japanese elections suggests that the results will somehow eliminate much of the domestic political tension that has been cited in both countries as a reason for treading lightly in certain sectoral negotiations. In other words, the United States will find it easier to achieve its goals in trade talks with Japan since Mr. Nakasone will be able to impose whatever results he desires in trade and other matters.

This assumption, however, amounts to a fundamental misunderstanding of Japanese factional politics and negotiating procedures. True, U.S. government officials and members of Congress seeking various trade objectives will no longer demonstrate any sympathy for Japanese officials pleading domestic political pressures to justify their inability to reach a compromise. Nevertheless, those pressures remain. The oppositionists have been only minor impediments in trade talks with the United States. The real problems have come from LDP legislators, and the LDP now has more representatives who will be forced to heed constituent interests if they are to remain in power. For example, the bilateral beef and citrus agreement is scheduled to expire in March 1988 and new negotiations are certain. In this case, the potential for the issue becoming even more contentious than the heated 1984 round is great, since almost two-thirds of the LDP Diet members elected in July represent rural or semi-agrarian districts. While all these representatives do not come from beef or citrus producing areas, they can be expected to be sympathetic to appeals from other agricultural groups to form coalitions to prevent sacrificing their interests to overseas pressure.

Furthermore, the Nakasone faction remains only one of several groups in the political process. It is true that the election results have given the prime minister increased political leverage, but that leverage could dissipate quickly, particularly if he is unable to translate it into a third term as LDP president. In any case, the interests of all major factions must be satisfied if any individual is to remain in power. If Mr. Nakasone can convince other groups that, for instance, increased market access is in Japan's best economic and political interests, then the two countries can look forward to stable economic relations, even as the United States enters its own political rituals. If he fails in that task -- and it will be difficult -- then frictions can be anticipated. (Japanese government negotiators would add that the approach to any bilateral dispute is determined on its merits, not on who is in power, and that Japan also remains committed to free trade as demonstrated by its market liberalizaton track record.)

U.S. politicians would be well advised, then, to avoid the assumption that because of the favorable election results, Mr. Nakasone can be counted on to "produce" at Washington's request. A related concern in Japan may be that the administration will look to Japan for support in the upcoming elections, on the grounds that it assisted the LDP by toning down trade disputes during a critical period.

Prospects

The dramatic LDP victory should result in four years of continued political stability in Japan. No politician would dissolve the lower house during the next four years when the LDP holds the greatest number of seats in its history. This should facilitate the development and implementation of economic and foreign policies in Japan and simplify its conduct of relations with other countries. A big question mark is the status of the prime minister. The course toward stability and what Japan's allies perceive as political dynamism would be more likely to continue under a Nakasone government.

Four more years will provide the ruling party with the continued opportunity to solidify its power over the government by grafting party policy-making organizations onto ministries and agencies. This trend has resulted in significant increases in the party's influence over the bureaucracy. In addition, it enables the party to maintain the elements of domestic politics that assure future success: patronage, leadership and financial strength.

The overwhelming victory, however, raises other questions. The opposition parties were in some respects bigger losers than the LDP was a winner. Although the oppositionists in total drew more votes than the LDP, no single party was able to muster sufficient votes to suggest that it has a viable, long-term future on its own or even as a coalition partner. Any number of factors could result in the next four years in increased voter support for the opposition, but its level of political importance now is so weak that the struggle toward credibility will be long and hard.

In the short term the leading opposition parties must resolve internal disputes before they can face the voters again, and the July balloting complicates this task. For example, the JSP's defeat may encourage more doctrinaire members to reassert their philosophy. (At this writing, the JSP was still pondering the fate of party chairman Masashi Ishibashi, who submitted his resignation because of his responsibility for the party's loss of 20-plus seats.) Such a development is not likely to enhance the JSP's long-term leadership potential, and many observers of the political scene in Japan would argue that the country lacks a truly viable political system until it develops a legitimate and credible opposition party.

On a smaller but still significant scale, this dilemma also faces the Democratic Socialist Party, a more moderate element in Japanese politics that has played an important role in such areas as formulating the country's defense policies. The overwhelming LDP victory might reduce the input of the party and force it to reassess its presence on the political scene. Potential identity crises face Komeito (the Clean Government Party) and the lackluster Japan Communist Party as well.

For the time being, however, there is nothing to suggest that the LDP will slip from its dominant position in the coming fours years, unless massive complacency or intra-party strife set in. The full dimensions of the victory will not be felt until the succession issue is resolved in the coming weeks, but for now, everything is copacetic at LDP headquarters.

For further information, contact Michael W. Chinworth.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

Japanese Lower House Elections, 1972-86

Number of Seats[1]

	1972	1976	1979	1980	1983	1986
LDP	271	249	248	284	250	300
JSP	118	123	107	107	112	85
Komeito	29	55	57	33	58	56
DSP	19	29	35	32	38	26
NLC	--	17	4	12	8	6
JCP	38	17	39	29	26	26
Shaminren	--	--	2	3	3	4
Independents/ Others	16	21	19	11	16	9
Total	491	511	511	511	511	512

Percentage of Seats[1]

	1972	1976	1979	1980	1983	1986
LDP	55.2%	48.7%	48.5%	56.0%	48.9%	58.6%
JSP	24.0	24.0	20.9	20.9	21.9	16.6
Komeito	5.9	10.8	11.2	6.5	11.4	10.9
DSP	3.9	5.7	6.8	6.3	7.4	5.1
NLC		3.3	0.8	2.3	1.6	1.2
JCP	7.7	3.3	7.6	5.7	5.1	5.1
Shaminren			0.4	0.6	0.6	0.8
Independents/ Others	3.3	4.1	3.7	2.2	3.1	1.8
Total*	100.0	100.0	100.0	100.0	100.0	100.0

[1] Final election results. Does not indicate number or percentage of party seats held in lower house following entry of independents or formation of coalition groups after elections.

*Totals do not add to 100 percent due to rounding.

Percentage of Votes Won

	1972	1976	1979	1980	1983	1986
LDP	46.9%	41.8%	44.6%	47.9%	45.8%	49.5%
JSP	21.9	20.7	19.7	19.3	19.5	17.2
Komeito	8.5	10.9	9.8	9.0	10.1	9.4
DSP	7.0	6.3	6.8	6.6	7.3	6.5
NLC	--	4.2	3.0	3.0	2.4	2.4
JCP	10.5	10.4	10.4	9.8	9.3	8.8
Shaminren	--	--	0.7	0.7	0.7	0.8
Independents/ Others	5.4	5.8	5.0	3.7	5.0	6.0
Total*	100.0	100.0	100.0	100.0	100.0	100.0
Voter Turnout	71.8	73.5	68.0	74.6	67.9	71.4

*Totals do not add to 100 percent due to rounding.

Major Liberal Democratic Party Factions

(as of July 10, 1986)

	Pre-election Total	Post-election Total	Change
Tanaka/Takeshita	120	141	21
Nakasone	57	83	26
Suzuki/Miyazawa	80	88	8
Fukuda/Abe	71	83	12
Komoto	34	34	0

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Diet Confirms New Cabinet

The Japanese Diet July 22 confirmed a new cabinet that reflects the changes resulting from the July 6 elections and forbodes future leadership transitions. Coupled with the new alignment were rumors that senior officials of the ruling Liberal Democratic Party had agreed to extend Yasuhiro Nakasone's term as LDP president -- and thus as prime minister -- beyond October 1986, the scheduled expiration date.

The most significant shifts in the new roster involve the three contenders to succeed Mr. Nakasone as party president and premier. Both Shintaro Abe, the foreign minister, and Noboru Takeshita, the finance minister, satisfied their personal ambitions by leaving the cabinet and nailing down LDP party positions -- Mr. Takeshita as LDP secretary general and Mr. Abe as executive council chairman. These changes allow them to solidify control of their personal factions, expand their influence within the party, and set the groundwork for their campaigns for the premiership. It also enables both men to distance themselves from current government policies, thus avoiding being tainted by views identified with the Nakasone government and allowing them to establish independent positions. In the short term, this is particularly important for Mr. Takeshita, who has been nicknamed "Mr. High Yen" for his role in driving up the value of the yen on international markets. Although less significant, Mr. Abe -- who recently was named chairman of the Fukuda faction -- might seek to place some distance between himself and the decidedly pro-defense posture of the present government.

The other key figure in Japan's political drama, former LDP executive council chairman Kiichi Miyazawa, was named finance minister. The appointment suggests several political and policy implications. The first is that the price of continued support for Mr Nakasone by the Suzuki faction was retention of its de facto leader in an important government position. The finance minister is a prestigious and influential post that will keep Mr. Miyazawa in the public eye. At the same time, however, the appointment restricts his options by tying him to the Nakasone government's policies. Of the three rivals, Mr. Miyazawa's positions have differed the most from the present government, on matters ranging from economic stimulus to defense. Although he will be able to influence policies to a degree, his political independence will be limited.

The move does suggest that Mr. Nakasone is serious about implementing the Maekawa Commission's suggestions to reform the domestic economy. It also means that if the government chooses to reflate Japan's economy, the Ministry of Finance will be less of an obstacle since Mr. Miyazawa has been the most vocal proponent of stimulus plans. The move will not automatically translate into stimulative policies, however, since MOF as a whole remains committed to tight budgets; years of budget-cutting gospel cannot be reversed overnight. Finally, Mr. Miyazawa assumes his post at a time when preparations for fiscal 1987 (April 1, 1987-March 31, 1988) are well under way. Preliminary budget spending guidelines have been established, limiting his influence on next year's fiscal policy.

This may also be the case with regard to defense policies. Under the Nakasone government, defense and official development assistance consistently have received higher increases than most other categories. Mr. Miyazawa is perhaps the most dovish of the three "New Leaders" in Japan. He was foreign minister when the government established the one percent of GNP limit on total defense spending. Coupled with his new position as finance minister, this may serve to reassure defense critics that the Nakasone government will attempt to honor the spending limit.

But it will not necessarily mean smaller spending increases. The prime minister remains committed to defense and the Japan Defense Agency's five-year plan has official status, which gives it greater leverage with the normally tight-fisted Finance Ministry. Furthermore, continuity in defense policies has been assured by the return of former JDA director general Yuko Kurihara, replacing Koichi Kato. If Mr. Miyazawa balks at higher defense spending, it would more likely be a result of MOF institutional interests than his personal preferences.

Replacing Mr. Abe as foreign minister is Nakasone associate Tadashi Kuranari. The designation of a Nakasone supporter in the post indicates that the prime minister plans to continue asserting his personal mold on Japan's international relations, although it is unlikely that the country's foreign policy will be altered drastically. (This is an important point for overseas observers who might mistakenly interpret Mr. Abe's departure as a change in Japan's foreign policies to keep in mind.) Because of his valued role in the July double elections, former LDP secretary general Shin Kanemaru was designated deputy premier.

One face that is missing is Susumu Nikaido's, former LDP vice president and once the right-hand man of "kingmaker" Kakuei Tanaka, whose influence within the party continues to dwindle. This could lead to his replacement as chairman of the Tanaka faction by Mr. Takeshita, whose influence over the group has been on the increase. Also absent is a member of the New Liberal Club, the LDP's coalition partner from December 1983 to July 1986. The Komoto faction placed one member in a relatively minor post.

With the cabinet changes in place, political observers now expect Mr. Nakasone's term as LDP president to be extended for at least one year. This would complete a remarkable series of developments within Japan and assure Mr. Nakasone's continuation in office as prime minister, an event that was considered virtually impossible two years ago. In political terms, the reshuffling also appears to give Messrs. Takeshita and Abe the superior position in the struggle to replace the incumbent.

Michael W. Chinworth

Fifth Nakasone Cabinet

July 22, 1986

Ministry	Name	Age	Faction
Prime Minister	Yasuhiro Nakasone*	68	Nakasone
Deputy Prime Minister	Shin Kanemaru	72	Tanaka
Justice	Kaname Endo	71	Tanaka
Foreign Affairs	Tadashi Kuranari	68	Nakasone
Finance	Kiichi Miyazawa	67	Suzuki
Education	Masayuki Fujio	69	Abe
Health and Welfare	Juro Saito	46	Tanaka
Agriculture, Forestry, Fisheries	Mutsuki Kato	60	Abe
International Trade and Industry	Hajime Tamura	62	Tanaka
Transportation	Ryutaro Hashimto	49	Tanaka
Posts/Telecommunications	Shunjiro Karasawa	56	Nakasone
Labor	Takushi Hirai	55	Nakasone
Construction	Kosei Amano	79	Nakasone
Home Affairs	Nobuyuki Hanashi	58	Suzuki

State Ministers

Cabinet Secretary	Masaharu Gotoda*	72	Tanaka
Management/Coordination	Tamaki Kazuo	63	Ind.
Hokkaido/Okinawa Development National Lands	Tamisuke Watanuki	59	Tanaka
Defense	Yuko Kurihara	66	Suzuki
Economic Planning	Tetsuo Kondo	57	Komoto
Science/Technology	Yataro Mitsubayashi	68	Abe
Environment	Toshiyuki Inamura	51	Tanaka
Legislative Director	Osamu Kimura	62	--

*Retained from previous cabinet.

Liberal Democratic Party Positions

President	Yasuhiro Nakasone	68	Nakasone
Vice President	Vacant	--	--
Secretary General	Noboru Takeshita	62	Tanaka
Chairman, Executive Council	Shintaro Abe	62	Abe
Chairman, Policy Affairs Research	Masayoshi Ito	73	Suzuki

Factional Balances in Cabinet Seats

(number of positions held excluding deputy prime minister)

	Previous Cabinet	Current Cabinet
Tanaka	6	7
Nakasone	4	5
Suzuki	4	2
Abe (Fukuda)	4	3
Komoto	2	1
New Liberal Club	1	0
Independent	1	2

MITI Forecasts 2.5 Percent Real Growth In FY 1986

The Ministry of International Trade and Industry predicted last week that the economy will grow an inflation-adjusted 2.5 percent in FY 1986, well below the official government projection of 4 percent real growth. MITI economists expect the yen's appreciation to reduce the volume of exports 5 percent and slow the economy from the 4.2 percent growth recorded in fiscal 1985. June's trade data showed a 2.3 percent drop in export volume, the fourth consecutive monthly year-on-year decline.

The MITI report agrees with the consensus of private economists. Twenty major research organizations forecast an average 2.4 percent real growth rate in FY 1986 (see Table), down 0.4 percentage point from earlier projections, which were based on an exchange rate of Y184=$1.00. They anticipate only a modest 3.3 percent rise in personal consumption (compared to 2.7 percent in FY 1985), despite a projected 9.2 percent drop in wholesale prices. And they expect private capital spending to increase at only 4.5 percent, one-third of the rate recorded in FY 1985. In addition, these groups say that Japan's current account surplus could rise from $55.1 billion in FY 1985 to $80.2 billion in the current fiscal year.

Revised Economic Forecasts for Fiscal 1986

(year-to-year percentage changes in real terms)

	GNP Growth	Personal Consumption Spending	Private Capital Spending	Current Account Surplus*	Yen-Dollar Exchange Rate
Daiwa Securities Research Institute	3.4%	3.5%	3.9%	$84.0	Y167
Sumitomo Trust and Banking	2.9	4.4	5.1	68.3	164
Kokusai Securities	2.8	2.9	4.4	89.0	163
New Japan Securities Co. Research Institute	2.6	3.5	4.4	78.0	168
Bank of Tokyo	2.6	3.6	4.7	79.4	164
Fuyo Data Processing & Systems Development	2.6	2.6	7.9	69.6	166
Nomura Research Institute	2.5	3.4	5.1	80.4	163
Yamaichi Research Institute of Securities & Economics	2.5	3.3	3.5	87.4	164
Nikko Research Center	2.5	2.9	4.4	88.9	165
Dai-Ichi Kangyo Bank	2.4	3.0	5.3	80.8	163
Mitsubishi Trust and Banking	2.4	3.5	3.5	75.5	168
Nikkei Economic Electronic Databank System	2.4	3.3	5.2	81.8	166
Kyoto University Institute of Economic Research	2.3	3.2	2.4	72.4	168
Japan Economic Research Center	2.3	3.2	4.6	81.7	170
Tokai Bank	2.2	3.5	4.3	85.0	163
Okasan Economic Research Institute	2.1	2.6	3.1	76.9	163
Yasuda Trust & Banking	2.1	3.3	4.7	81.2	170
C. Itoh & Co.	2.1	3.0	4.5	79.5	170
Industrial Bank of Japan	2.0	3.6	5.6	74.4	162
Mitsubishi Research Institute	1.8	2.8	2.9	89.5	161
Average	2.4	3.3	4.5	80.2	165

*In billions of dollars

Source: Japan Economic Journal, July 19, 1986.

Despite the slowing economy, the Ministry of Finance continues to press for a 10 percent cut in general operating expenditures and a 5 percent reduction in investment-related programs funded through the general account budget. This plan to reduce discretionary spending for the fifth consecutive year is supported by a MOF advisory council chaired by Yoshihiro Inayama. The effort to rebuild the nation's finances is at a critical stage, Mr. Inayama told a Tokyo press conference July 16, given the rising support among business and Liberal Democratic Party leaders for increased government spending to offset the deflationary effects of the strong yen.

A government-commissioned report released last week by the Economic Planning Agency, however, urged the government to maintain the budget deficit at its current level. The study, prepared by the Mitsubishi Research Institute, said that if Japan is to reduce its large trade surplus with the United States, Tokyo's plan to end its budget deficit by FY 1990 must be shelved temporarily and the United States will have to shrink its budget deficit.

The debate over fiscal stimulus centers on the size of the supplementary budget proposed for this fall. Prime Minister Yasuhiro Nakasone promised to consider expenditures of up to Y3 trillion ($18.8 billion at Y160=$1.00), which senior MITI officials believe is necessary if the country is to achieve 4 percent real growth in FY 1986. This position recently received support from the former head of the Economic Planning Agency, Wataru Hiraizumi, who added that the government should not wait until autumn to stimulate the economy. Predictably, the outgoing finance minister, Noboru Takeshita, expressed reservations about a supplementary budget since it would require the government to float more construction bonds.

Randall S. Jones

Agenda For New Round Of Multilateral Trade Talks Approved

A draft agenda for a new round of multilateral trade negotiations that includes services, intellectual property and agriculture has been approved by a majority of member countries of the General Agreement on Tariffs and Trade. The agenda also includes a freeze on new protectionist measures and a rollback of existing barriers. A group of developing nations, led by Brazil and India, is demanding the rollback as a precondition for the launching of a new round. The draft will be discussed at the GATT ministerial meeting scheduled for September 15 at Punta del Este, Uruguay, which is expected to launch the trade talks.

Brazil, Argentina and India appear to have lost their fight to exclude trade in services from the negotiations. They had argued that international rules on services trade would permit foreign interference in sovereign areas, such as banking, and that their service industries would not be able to compete with those in the advanced countries. The United States, Japan and the European Community insisted on the inclusion of services, given its rising importance in their economies. To achieve a meaningful agreement on services with the developing countries, though, the industrialized countries will probably have to open their markets to more third world imports.

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REPORT

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RESEARCH AND DEVELOPMENT IN JAPAN: AN UPDATE

Summary

Japan's research and development effort, which increased at an average annual rate of 17 percent in the first half of the 1970s and 11.7 percent in the second half, has continued to grow at a double-digit average annual rate in the 1980s. Although there has been a great deal of debate about increasing the share of R&D funds allocated to basic research, the greater proportion still is spent on applied research and product development. Also noteworthy is the continuing shift of R&D responsibilities to the private sector, as limited budget growth forces government agencies to target their research monies more carefully.

Overall Outlays

According to data compiled by the Management and Coordination Agency, Japan spent almost Y7.9 trillion ($49.3 billion at Y160=$1.00) on R&D activities in fiscal 1984 (ended March 31, 1985), keeping the growth rate near FY 1983's 10 percent gain (see Table 1). Since this rate was significantly above the expansion of the entire economy, research outlays in relation to gross national product rose that year to 2.6 percent from 2.53 percent. This put Japan quite close in percentage terms to the United States, which spent 2.65 percent of GNP on research activities in calendar 1984.

Private industry continued to account for the lion's share of research spending (65.1 percent), followed by universities (21.8 percent) and research institutes (13.1 percent). In fact, companies have been steadily expanding their share of R&D outlays. During the first half of the 1980s, business-

Table 1: Japan's R&D Expenditures, FY 1980-FY 1984

(in billions of yen and percent)

a. By Organization

Fiscal Year	Companies	Research Institutions	Universities	Total
1980	Y3,142.3	Y763.9	Y1,340.1	Y5,246.2
Change	17.9%	15.7%	6.5%	14.5%
Share	59.9%	14.6%	25.5%	100.0%
1981	3,629.8	906.9	1,445.6	5,982.4
Change	15.5%	18.7%	7.9%	14.0%
Share	60.7%	15.2%	24.2%	100.0%
1982	4,039.0	949.3	1,540.4	6,528.7
Change	11.3%	4.7%	6.6%	9.1%
Share	61.7%	14.5%	23.6%	100.0%
1983	4,560.1	971.0	1,649.6	7,180.8
Change	12.9%	2.3%	7.1%	10.0%
Share	63.5%	13.5%	23.0%	100.0%
1984	5,136.6	1,033.1	1,724.2	7,893.9
Change	12.6%	6.4%	4.5%	9.9%
Share	65.1%	13.1%	21.8%	100.0%

b. By Source

Fiscal Year	Government	Private	Foreign	Total
1980	Y1,465.0	Y3,776.3	Y4.9	Y5,246.2
Change	8.2%	17.0%	36.1%	14.5%
Share	27.9%	72.0%	0.1%	100.0%
1981	1,612.4	4,363.8	6.1	5,982.4
Change	10.1%	15.6%	24.5%	14.0%
Share	27.0%	72.9%	0.1%	100.0%
1982	1,666.2	4,855.5	7.0	6,528.7
Change	3.3%	11.3%	14.8%	9.1%
Share	25.5%	74.4%	0.1%	100.0%
1983	1,721.4	5,451.1	8.2	7,180.8
Change	3.3%	12.3%	17.1%	10.0%
Share	24.0%	75.9%	0.1%	100.0%
1984	1,777.8	6,108.6	7.6	7,893.9
Change	3.2%	12.1%	-7.3%	9.9%
Share	22.5%	77.4%	0.1%	100.0%

Source: Management and Coordination Agency

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initiated R&D advanced at an average annual rate of 13.1 percent, while work by universities and research institutes increased by 6.3 percent and 8.9 percent, respectively.

The same trend is reflected in a breakdown of research expenditures by funding source. The private sector underwrote 77.4 percent of research spending in FY 1984 compared with 72 percent in FY 1980. Again, this shift was the result of simple arithmetic: government outlays advanced at only a 5.5 percent average annual pace in this decade's first half, while private funding grew 12.8 percent a year during the same time.

It is also interesting to note the strong growth of foreign-funded research in Japan. Although foreign firms have found it difficult to penetrate Japan's research circles, it is expected that they will continue to build a presence there. Given the numbers involved, it is obvious that foreigners will always play a relatively small role in Japan's overall R&D picture. However, their presence signifies the erosion of the "not invented here" syndrome that has blinded foreigners to Japan's technological contributions.

Private Firms Maintain Hot Pace

The nation's commitment to advanced technology is apparent from the fact that R&D growth is evenly divided throughout industry (see Table 2). Some industries, including nonelectric machinery makers and steel mills, are characterized by a steady growth in research outlays, while others, pharmaceutical companies and manufacturers of fabricated metal products, for example, follow a boom-and-bust pattern. The highs and lows seem to cancel each other out, however, resulting in steady aggregate expansion.

When research outlays are compared to gross sales and pretax profits, Japan's research picture is similar to the United States' (see Table 3). According to Business Week's annual R&D survey, research spending by big U.S. corporations averaged 2.6 percent of sales and 31 percent of pretax profits in 1983, rising to 2.9 percent of sales and 32.7 percent of profits the following year -- a better performance than Japan's based on the sales indicator but nearly identical relative to profits. In terms of the ratio of R&D expenditures to pretax profits, however, Japanese firms in several industries easily outspent U.S. companies. For example, Japanese automotive makers earmarked sums equal to 84.5 percent and 71.8 percent of pretax profits in FY 1983 and FY 1984, while the ratios for U.S. producers came to 61.8 percent in 1983 and 43 percent in 1984. The same situation exists in electronics, precision equipment and pharmaceuticals as well. To be sure, American firms shell out vastly greater absolute sums (General Motors Corp. alone outspends nearly all its Japanese competitors combined), but Japanese companies are clearly putting the goal of advancing technology ahead of advancing profits (see Table 4).

Government Research Slowed by Austerity

Prime Minister Yasuhiro Nakasone's pledge to reduce the budget deficit by holding the line on spending has sharply cut the expansion of government research outlays. After remaining one step behind private industry in both FY 1980 and FY 1981, the growth in government funding slowed to only 3 percent-plus a year in the FY 1982-FY 1984 period -- a rate that was maintained in the year through April 1986. Although this fiscal year's planned 4.8 percent rise is a distinct improvement, it remains a far cry from the 8-10 percent gains made before Mr. Nakasone's arrival.

Table 2: Japan's R&D Expenditures By Industry, FY 1983-FY 1984

(in billions of yen and percentage change)

	FY 1983		FY 1984	
	Total	Change	Total	Change
Agriculture	Y5.7	20.7%	Y4.8	-15.5%
Mining	15.6	0.2	18.8	20.2
Construction	101.3	25.7	116.1	14.6
Manufacturing	4,257.2	13.4	4,776.5	12.2
Food Products	111.2	5.9	123.7	11.3
Textiles	51.0	-1.6	59.5	16.6
Pulp and Paper	25.7	30.9	29.1	13.3
Publishing and Printing	11.5	42.5	13.9	20.6
Chemicals	774.5	12.7	852.8	10.1
Industrial Chemicals and Synthetic Fibers	297.7	8.9	346.3	16.3
Oils and Paints	75.0	11.8	84.3	12.4
Pharmaceuticals	289.9	20.9	295.3	1.9
Other	112.0	4.5	127.0	13.4
Petroleum and Coal Products	49.8	14.4	56.0	12.3
Plastic Products	51.8	n.a.	64.0	23.5
Rubber Products	57.8	3.5	68.4	18.4
Nonmetallic Mineral Products	113.3	21.0	131.3	15.9
Steel	186.1	1.8	192.1	3.2
Nonferrous Metals	74.0	2.6	87.7	18.5
Fabricated Metal Products	82.8	27.7	83.5	0.8
Nonelectric Machinery	311.7	10.9	337.5	8.3
Electric Machinery	1,416.2	20.4	1,634.5	15.4
Communications and Electronics Equipment	958.6	21.3	1,096.4	14.4
Other	457.6	18.6	538.2	17.6
Transportation Equipment	714.5	6.3	808.2	13.1
Motor Vehicles	605.8	6.4	686.7	13.3
Other	108.7	6.1	121.5	11.8
Precision Machinery	158.8	18.3	167.4	5.4
Other	118.3	10.2	67.0	-43.4
Transportation, Communications and Utilities	180.3	-1.2	220.5	22.3
Total	4,560.1	12.9	5,136.6	12.6

Source: Management and Coordination Agency

Table 3: Japan's Ratio of Corporate R&D Expenditures to Gross Sales and Pretax Profits, By Industry, FY 1983-FY 1984

(in percent)

	FY 1983		FY 1984	
	Sales	Profits	Sales	Profits
Agriculture	0.26%	12.7%	0.24%	10.6%
Mining	0.66	5.0	0.68	5.1
Construction	0.54	13.9	0.48	16.7
Manufacturing	2.31	48.6	2.34	38.9
Food Products	0.70	17.5	0.60	16.8
Textiles	0.90	23.1	1.16	32.0
Pulp and Paper	0.63	10.3	0.66	9.6
Publishing and Printing	0.43	5.8	0.61	11.8
Chemicals	3.34	52.9	3.46	53.9
Industrial Chemicals and Synthetic Fibers	2.32	44.6	2.47	40.9
Oils and Paints	2.83	72.3	3.09	74.5
Pharmaceuticals	6.59	63.6	6.49	75.9
Other	3.40	47.4	3.76	54.4
Petroleum and Coal Products	0.26	11.4	0.27	12.4
Plastic Products	n.a.	n.a.	1.94	40.8
Rubber Products	2.40	57.1	2.62	55.1
Nonmetallic Mineral Products	1.82	28.6	1.96	26.8
Steel	1.60	42.5	1.52	21.1
Nonferrous Metals	1.49	42.2	1.64	44.8
Fabricated Metal Products	1.31	26.1	1.46	25.5
Nonelectric Machinery	2.57	51.6	2.59	47.3
Electric Machinery	4.70	73.3	4.55	66.9
Communications and Electronics Equipment	4.85	76.7	4.60	65.5
Other	4.40	66.9	4.45	70.0
Transportation Equipment	2.66	73.4	2.76	68.1
Motor Vehicles	2.89	84.5	2.90	71.8
Other	1.86	42.3	2.20	52.9
Precision Machinery	4.02	64.7	4.08	62.8
Other	1.40	31.3	0.92	3.2
Transportation, Communications and Utilities	1.04	6.7	0.92	7.2
All Industry Average	1.97	35.3	2.00	31.2

Source: Management and Coordination Agency

Table 4: Corporate R&D Expenditures, Top Ten for 1985

(in millions of dollars and percent)

Japan	R&D Expenditures*	Percent Change	Share of Sales
Hitachi, Ltd.	$1,050	12.0%	8.3%
Toyota Motor Corp.	1,018	9.1	4.0
NEC Corp.	975	15.0	11.2
Matsushita Electric Industrial Co., Ltd.	933	9.9	6.4
Nissan Motor Co., Ltd.	721	9.7	4.4
Fujitsu, Ltd.	636	18.5	10.0
Honda Motor Co., Ltd.	509	13.8	5.4
Mitsubishi Electric Corp.	449	9.3	5.6
Mazda Motor Corp.	339	17.3	5.1
Mitsubishi Heavy Industries Co., Ltd.	335	-1.6	4.3

United States	R&D Expenditures	Percent Change	Share of Sales
General Motors Corp.	$3,625	18.0%	3.8%
International Business Machines Corp.	3,457	10.0	6.9
American Telephone & Telegraph Co.	2,210	1.0	6.3
Ford Motor Co.	2,018	5.0	3.8
E.I. DuPont de Nemours & Co.	1,144	4.0	3.9
ITT Corp.	1,085	14.0	9.1
General Electric Co.	1,069	3.0	3.8
Eastman Kodak Co.	976	16.0	9.2
United Technologies Corp.	916	-2.0	6.1
Digital Equipment Corp.	717	14.0	10.7

*An exchange rate of Y238.53=$1.00 was used to convert the Japanese data.

Sources: Nihon Keizai Shimbun, December 11, 1985, and Business Week, June 23, 1986.

That growth has occurred at all is due to the fact that the prime minister has made science and technology one of the few exceptions to the no-increase budget rule (see JEI Report No. 16A, April 25, 1986). Nevertheless, after years of fiscal austerity, it is clear that particular ministries are gaining at the expense of others (see Tables 5 and 6). The Science and Technology Agency and the Ministry of International Trade and Industry have found their activities just as susceptible to the budget ax as any other organization. Even the near-sacrosanct Japan Defense Agency has seen the rate of its R&D expansion cut drastically.

Table 5: Japanese Government R&D Expenditures, FY 1985

(in millions of yen and percentage change)

	Science Promotion	Energy Research	Other Research	Special Research	Total
Diet	Y517 0.0%	Y0 --	Y0 --	Y0 --	Y517 0.0%
Japan Technology Council	0 --	0 --	889 12.8%	0 --	889 12.8%
Police Agency	847 1.0%	0 --	0 --	0 --	847 1.0%
Hokkaido Development Agency	141 0.0%	0 --	0 --	0 --	141 0.0%
Defense Agency	0 --	0 --	58,677 31.5%	0 --	58,677 31.5%
Economic Planning Agency	704 -1.6%	0 --	0 --	0 --	704 -1.6%
Science and Technology Agency	146,986 4.4%	165,700 7.4%	16,843 -50.7%	83,809 15.6%	413,337 2.9%
Environmental Agency	8,524 -3.3%	0 --	1,655 -0.8%	0 --	10,179 -2.9%
Land Agency	298 *	0 --	0 --	0 --	298 *
Justice Ministry	787 1.6%	0 --	0 --	0 --	787 1.6%
Foreign Ministry	0 --	2,633 5.8%	3,633 3.9%	0 --	6,266 4.7%
Finance Ministry	318 2.5%	0 --	0 --	578 2.9%	897 2.8%
Education Ministry	55,888 0.9%	0 --	123,650 -1.0%	534,251 -0.0%	713,789 -0.1%
Health Ministry	26,333 5.3%	0 --	1,296 1.1%	6,130 11.2%	33,759 6.1%
Agriculture Ministry	59,539 1.9%	0 --	1,727 -2.9%	0 --	61,266 1.8%
International Trade and Industry Ministry	59,069 -1.0%	4,407 -16.2%	10,147 -2.1%	119,563 24.3%	193,186 12.7%
Transportation Ministry	11,400 -23.2%	0 --	524 -0.1%	1,383 73.1%	13,306 -17.7%
Posts and Telecommunications Ministry	4,209 -5.7%	0 --	49 -29.2%	10,000 *	14,258 214.4%
Labor Ministry	585 -0.6%	0 --	1 -10.0%	2,233 -30.9%	2,819 -26.2%
Construction Ministry	4,915 3.4%	0 --	271 -76.1%	0 --	5,185 -11.9%
Home Rule Ministry	515 0.4%	0 --	0 --	0 --	515 0.4%
Total	381,575 1.3%	172,739 6.6%	219,361 -2.4%	747,947 4.9%	1,521,622 3.0%

*New allocation

Source: Management and Coordination Agency

Table 6: Japanese Government R&D Expenditures, Planned FY 1986

(in millions of yen and percentage change)

	Science Promotion	Energy Research	Other Research	Special Research	Total
Diet	Y517	Y0	Y0	Y0	Y517
	0.0%	--	--	--	0.0%
Japan Technology Council	0	0	863	0	863
	--	--	-2.8%	--	-2.8%
Police Agency	899	0	0	0	899
	6.1%	--	--	--	6.1%
Hokkaido Development Agency	142	0	0	0	142
	0.7%	--	--	--	0.7%
Defense Agency	0	0	66,133	0	66,133
	--	--	12.7%	--	12.7%
Economic Planning Agency	704	0	0	0	704
	0.1%	--	--	--	0.1%
Science and Technology Agency	154,277	167,708	8,497	89,860	420,342
	5.0%	1.2%	-49.7%	7.2%	1.7%
Environmental Agency	8,320	0	0	0	8,320
	-2.4%	--	--	--	-2.4%
Land Agency	210	0	0	0	210
	-29.8%	--	--	--	-29.8%
Justice Ministry	808	0	0	0	808
	2.7%	--	--	--	2.7%
Foreign Ministry	0	2,578	4,017	0	6,594
	--	-2.1%	10.6%	--	5.2%
Finance Ministry	329	0	0	610	938
	3.2%	--	--	5.5%	4.7%
Education Ministry	57,745	0	124,807	563,039	745,591
	3.3%	--	0.9%	5.4%	4.5%
Health Ministry	28,015	0	1,251	6,856	36,121
	6.4%	--	-3.5%	11.8%	7.0%
Agriculture Ministry	60,733	0	1,944	3,800	66,477
	2.0%	--	12.6%	*	8.5%
International Trade and Industry Ministry	56,427	3,404	10,675	147,050	217,557
	-4.5%	-22.7%	-0.9%	18.2%	9.5%
Transportation Ministry	11,511	0	571	1,188	13,271
	1.0%	--	-0.6%	2.0%	1.0%
Posts and Telecommunications Ministry	4,126	0	41	20,500	24,667
	-2.0%	--	-16.1%	105.0%	73.0%
Labor Ministry	599	0	1	2,371	2,970
	2.4%	--	0.0%	5.8%	5.1%
Construction Ministry	5,065	0	751	0	5,817
	3.1%	--	177.5%	--	12.2%
Home Rule Ministry	527	0	0	0	527
	2.5%	--	--	--	2.5%
Total	390,954	173,690	219,551	814,773	1,598,969
	2.5%	0.6%	0.5%	8.3%	4.8%

*New allocation

Source: Management and Coordination Agency

A careful examination of government-sponsored research programs reveals a mixed pattern, as each ministry sets its own priorities (see Table 7). MITI reports that some of its projects are in the process of being shifted to the private sector, which accounts for some cuts, but even its treasured Next Generation Basic Technology program is being pared in fiscal 1986. All bodies except the Science and Technology Agency seem to be focusing consistently on applied projects, despite numerous advisory council and ministry reports advocating more funding for basic research.

Table 7: Expenditures on Selected Science Programs, by Agency, FY 1985-FY 1986

(in millions of yen)

	FY 1985	FY 1986
Defense Agency		
Technology development	Y57,819	Y65,259
Science and Technology Agency		
Agency research (including four air and space development organizations)	23,245	25,125
Physical Chemistry Research Institute	11,096	13,793
New Technology Development Association	1,756	1,737
Science and technology promotion survey	4,203	4,514
Space Development Association	88,861	90,659
Ocean development research	6,857	6,631
Ocean Science and Technology Center	6,700	6,437
Japan Nuclear Development Research Institute	99,674	101,556
Japan Reactor Development Center	65,769	65,925
National Nuclear Research Laboratory	1,733	1,774
International technology cooperation	9,241	0
Research management costs	7,602	8,497
Environment Agency		
National Disaster Research Institute	4,361	4,266
National Water-borne Disease Center	425	426
National Disaster Prevention Institute	2,765	2,625
Disaster prevention survey	884	883
Foreign Ministry		
International Atomic Energy Commission	2,633	2,578
OECD Nuclear Power Committee	179	181
Finance Ministry		
Brewing Research Institute	318	329
Education Ministry		
Ministry research (including six education centers)	6,531	6,680
Research grants	42,000	43,500
Japan Technology Promotion Council grants	3,480	3,781
Health Ministry		
Agency research (including seven population research projects)	9,642	9,858
Research grants	11,870	12,860
Radiation effects research	1,862	1,946
Health science research	2,448	2,842
Cancer research projects	1,388	1,388
International cancer research	213	132
Medical and drug information system	246	263

Agriculture Ministry		
Agency research laboratories (including 18 agricultural research centers)	Y43,437	Y44,547
Agricultural technology development	9,308	9,370
Large-scale projects	1,444	1,366
Biotechnology development	1,058	1,241
Research machinery and equipment	2,066	2,066
Agricultural technology promotion	2,090	2,090
Agricultural machinery research	Y788	Y810
Red tide research	226	224
Food product technology	385	602
International Trade and Industry Ministry		
Agency research (including 15 research centers)	24,252	25,176
Large-scale industrial technology projects	7,698	5,275
Computer industry promotion projects	4,779	4,501
Next generation basic technology projects	6,445	5,644
Key technology research and development	1,284	0
New energy technology projects	3,022	2,378
Energy conservation projects	1,385	1,026
Private transportation project (YXX aircraft)	1,371	714
Private aircraft jet engine project	3,829	3,987
Small business technology improvement	1,397	1,397
Transportation Ministry		
Agency research (including four ship technology centers)	7,122	7,168
Geostationary weather satellite management	1,829	2,032
Geostationary weather satellite launches	2,306	2,167
Magnetic levitation train technology	300	300
Posts and Telecommunications Ministry		
Electrotechnical laboratories	4,209	4,126
Construction Ministry		
Agency research (including one engineering center)	4,305	4,435

Source: Management and Coordination Agency

Sowing R&D Seeds

Like a modern-day Johnny Appleseed, MITI is trying to spread the reach of high technology deep into the countryside. The centerpiece of these efforts is the Technopolis regional development program. Initiated in 1981 and implemented at the start of fiscal 1984, it called for the development of 14 regional centers by the year 2000. The program has been attacked by critics who assert that it is merely a coordinated advertising campaign for local investment. In response, MITI added a new "research core" program for fiscal 1986 that builds on the Technopolis concept with 28 new local technology centers. The focus of the centers will be purely technological -- conducting research, training researchers, and transfering the technology to local businesses -- as opposed to the general development goals of the Technopolis program. MITI is not committing much money to the new program, but will use tax incentives to attract private investment.

MITI's Small Business Agency will join the regional research effort this year with its Technology Pioneer and Local Technology Development programs.

The Technology Pioneer plan aims at expanding the use of robots and computer-aided design/computer-aided manufacturing (CAD/CAM) techniques in small companies. A wide range of applications is expected, including software development, integrated circuit design, light manufacturing, biotechnology and new materials. The Local Technology Development effort has targeted eight prefectures for specific projects ranging from faster integrated circuit layout to improving noodle production techniques.

Other ministries and agencies also have regional development plans or are considering such steps. The most significant to date is the Ministry of Education's efforts to establish community colleges that focus on high technology. These national engineering schools offer courses in the following fields: energy, production systems, electrical and electronic engineering, materials, regional planning, and information and computer science. They also sponsor technology development centers that serve as direct links with local businesses, providing technical advice, new technology and coordinating joint research. Industry researchers are also welcome to participate in commissioned research projects.

Problems and Outlook

While everything may seem rosy, Japan still faces some significant hurdles to developing a balanced research and development environment. Tokyo set out six years ago to emphasize basic research, a policy that has yet to have a visible impact. Everyone talks about the importance of basic research, but funds have been only gradually moved toward this area. The shifting funding balance between the public and private sectors is likely to exacerbate this sluggish trend. While Japanese corporations recognize the importance of basic research to industry leadership, it is still difficult for them to divert money from product development. This would seem to argue for an increased role in basic research by the government. Unfortunately, budget restrictions and entrenched programs make a rapid shift to this focus nearly as difficult.

The second major problem that Tokyo is only slowly addressing is the relationship between academia and private industry. Despite efforts to create research consortia with scientists from both groups, avenues of contact remain quite limited. Industry is willing, if not anxious, to sponsor research at universities and cooperate in joint projects, but the Ministry of Education and rigid university procedures have blocked progress.

MOE limits the number of private researchers working in national university laboratories. Why the ministry follows this policy is not clear. If a Japanese company is lucky enough to gain MOE's permission to place a scientist in such a lab, it must pay a research fee to the ministry as well as foot the bill for all research costs. The alternative is to persuade a university professor to invite an industry-sponsored scientist to participate in a project. In this case, MOE's permission is not required, but the application must run the gamut of university faculty politics to gain departmental approval. The cost of this route is lower since no fee is paid to MOE.

A solution to the industry-academia research problem has been overshadowed by the heated debate over the basic shape of the educational system. Despite Prime Minister Nakasone's determination to push for reform, it could be some time before Japanese university and private scientists can meet in as open an environment as in the United States.

To compensate for these two weaknesses, Japan is taking advantage of academic research in the United States. The number of Japanese researchers and students working in this country has been growing steadily over the past several years. American subsidiaries of Japanese corporations are exploring links with universities across the country. Clearly, Japanese companies are seeking to capitalize on the mature U.S. basic research infrastructure while they slowly build up their own. Just as clearly, the U.S. scientific community benefits from the presence of meticulous Japanese researchers and the deep pockets of Japanese firms.

The situation presents some delicate questions. Is there a truly reciprocal flow of technology? Are we mortgaging our technological future by allowing foreign scientists to tap our best research? The answer to these questions is being debated in Washington. Tokyo is trying to reduce tensions by sponsoring more joint research and launching new international research projects. Whether this will be enough remains uncertain. The potential for an anti-Japanese backlash is clear. Such a reaction, however, would also harm the U.S. R&D effort. The two nations have become very interdependent in terms of technology, and policymakers are just beginning to deal with this reality.

In the meantime, Japan's domestic research efforts will continue to grow at a healthy pace, due primarily to spending by private industry. While Japan's research community may be short on basic research, it is not lacking in forward vision. Technological innovation and progress will continue to be embodied in Japanese products, which can be expected to maintain their global appeal.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI

REPORT

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Cabinet Adopts Austere Fiscal 1987 Budget Guidelines

The Japanese cabinet has endorsed stringent guidelines for fiscal 1987 budget requests, calling for a 10 percent cut in spending by most ministries and agencies. The plan adopted July 21 sets overall discretionary spending (total outlays less debt service costs and transfers to local governments) in the April 1987-March 1988 period at Y32,914.2 billion ($205.7 billion at Y160=$1.00), a 1 percent increase from the current fiscal year (see Table 1).

The proposed 10 percent cut in general operating expenditures and planned 5 percent reduction in investment-related programs will be offset by increases in five programs -- defense, official development assistance, social welfare, personnel costs, and science and technology. Detailed budget plans will be submitted by the end of August to the Finance Ministry, which will then prepare a draft budget for release at the end of 1986. The budget guidelines, negotiated by former Finance Minister Noboru Takeshita, are unlikely to be affected by the arrival of the new finance minister, Kiichi Miyazawa, who has called for increased government spending to reflate the economy. Mr. Miyazawa said he has agreed with the prime minister to "flexibly" carry out the government's fiscal reconstruction program aimed at balancing the budget by fiscal 1990.

Defense spending is slated for a 6.3 percent increase, down from a proposed 7 percent for both the current fiscal year and FY 1985 (see Table 2). The Japan Defense Agency had reportedly pushed a 7.2 percent rise to help fulfill the five-year defense buildup program started this year. Mr. Takeshita had offered 3 percent, arguing that lower oil prices and reduced pension payouts attributable to a slower rate of retirement in the Self-Defense forces would hold down costs. The compromise will raise defense spending by Y210.6 billion ($1.3 billion), bringing total expenditures close to the one percent of gross national product ceiling.

A 5.3 percent rise has been penciled in for social welfare spending, while ODA outlays are tentatively scheduled to expand 7.5 percent, down from FY 1986's 10 percent proposed increase. Former Foreign Minister Shintaro Abe noted that, given the yen's sharp appreciation, foreign aid would increase more than 10 percent in dollar terms, keeping Tokyo on track with respect to its goal to double the level of ODA spending during the next seven years.

MOF continues to adhere to austere fiscal policies despite increased pressure from business and Liberal Democratic Party leaders for additional government spending to boost the economy. The planned increase in discretionary spending in FY 1987 is 0.5 percentage point less than the 1.5 percent proposed increase for the current year's budget. Moreover, it should be noted that in the budget approved by the Diet for fiscal 1986, discretionary spending actually was reduced for the fourth consecutive year.

Any fiscal stimulus, therefore, will have to come from the supplementary budget planned for this fall. To compensate for the FY 1987 budget's proposed 5 percent cut in public works spending, MOF has agreed to negotiate with the Construction Ministry for additional outlays in this fall's supplementary budget. Prime Minister Yasuhiro Nakasone instructed Mr. Miyazawa to stress aid to smaller businesses and housing construction. The new finance minister told the prime minister that he will determine the size of the budget, which may be as large as Y3 trillion ($18.8 billion), after consulting with ministry aides.

Tetsuo Kondo, the new director general of the Economic Planning Agency, said he supports a large supplementary budget, even though it will require new issues of construction bonds. This will not conflict with the government's fiscal reconstruction policy, he said, since it will lead to faster economic growth and additional tax revenues.

Business leaders, though, are hoping for more than a supplementary budget. The leaders of four major business groups met with Mr. Nakasone on July 23 to present a plan to stimulate the economy. The package includes income and corporate tax cuts and tax breaks on housing and capital investment to stimulate domestic demand. The group also called for concerted action with other countries to stabilize the yen-dollar exchange rate.

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Table 1: Proposed Changes in Budget for FY 1987

(spending increase or decrease in billions of yen)

	FY 1986	FY 1987
Overall Discretionary Outlays	Y480.0 (1.5%)	Y330.0 (1.0%)
Defense	219.6 (7.0%)	210.6 (6.3%)
Official Development Assistance	58.0 (10.0%)	47.0 (7.5%)
Alternative Energy Development	20.0	-39.0
Disaster Relief	210.0	170.0
Personnel Costs	167.0	162.0
Pensions	435.0	520.0
International Science and Technology Cooperation	17.0	18.0

Source: Nihon Keizai Shimbun, July 21, 1986.

Table 2: Increases in Defense Spending*

Fiscal Year	Budget Guideline	Initial Budget
1982	7.5%	7.8%
1983	7.3	6.5
1984	6.9	6.6
1985	7.0	6.9
1986	7.0	6.6
1987	6.3	?

*For both the budget guideline and the initial budget, the base for comparison is the previous year's initial budget.

Source: Nihon Keizai Shimbun, July 21, 1986.

Tokyo Nears SDI Decision

Tokyo is said to be nearing a final decision on the question of Japan's participation in the controversial Strategic Defense Initiative. Quoting informed sources, recent press accounts say that by early fall, Tokyo will approve private-sector cooperation, with a decision on participation by government laboratories to follow. Although it is not yet clear if research sponsored by the Japanese government will in fact be available to the SDI program, a decision paving the way for the private sector's inclusion is expected to satisfy the United States, since most authorities feel that the technologies of greatest potential interest to the program are in this sector.

The policy implications of the decision are significant. Japan's 1983 decision to allow transfers of military technology to the United States

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Japan's Current Account Surplus Continues To Increase Despite Decline In Export Volume

Capped by a $7.6 billion surplus in June, Japan's current account balance -- which includes trade, services and transfers -- hit a record $35.9 billion in the first half of 1986, compared to $20.1 billion during the same period of 1985 (see Table 1). It therefore appears likely that the surplus for 1986 will reach the $77 billion mark predicted by the Organization for Economic Cooperation and Development. It is equally probable that trade on a balance of payments basis will come close to the OECD's projection of an $84.8 billion surplus since, in just the January-June period, exports exceeded imports by $38.4 billion, up from $23.1 billion in 1985's first six months.

The rising current surplus reflects a reduction in the services deficit in addition to the expanding trade surplus. The services deficit in the first

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half of 1986 was $1.3 billion, compared to $2.2 billion during the same period of 1985; the June deficit was just $29 million. In particular, net income from overseas investments continues to rise, reflecting Japan's position as the largest net creditor nation.

Table 1: Japan's Balance of Payments

(in millions of dollars)

	Trade Balance	Exports (f.o.b.)	Imports (f.o.b.)	Services (net)	Current Account Balance	Long-Term Capital (net)
1981	$19,967	$149,522	$129,555	$-13,573	$4,770	$-9,672
1982	18,079	137,663	119,584	-9,848	6,850	-14,969
1983	31,454	145,468	114,014	-9,106	20,799	-17,700
1984	44,257	168,290	124,033	-7,747	35,003	-49,651
1985	55,986	174,015	118,029	-5,165	49,169	-64,542
1985:I	8,937	38,164	29,227	-1,565	6,818	-10,355
1985:II	14,193	43,239	29,046	-611	13,262	-17,166
1985:III	15,077	43,469	28,392	-1,641	13,095	-18,309
1985:IV	17,779	49,143	31,364	-1,348	15,994	-18,712
1986:I	14,593	45,089	30,496	-1,163	12,718	-18,950
1986:II(p)	23,765	52,247	28,482	-150	23,158	-29,149

Source: Bank of Japan

Japan's continuing record surpluses have given rise to increasing doubts about the effectiveness of exchange rate changes in reducing trade imbalances. A study by World Economic Information Services, which assumes an exchange rate of Y168=$1.00, predicts that Japan's total trade surplus on a payments basis in 1988 will reach $96.7 billion (compared to $56 billion last year). The Bank of Japan's latest quarterly report called for expansion of domestic demand and structural changes, including tax reform, business deregulation and urban redevelopment, to increase imports. Bank of Japan governor Satoshi Sumita, who views the external trade imbalance as the largest issue facing Japan's economy, has stressed that exchange rate realignments alone can have only a limited effect on the trade imbalance.

Changes in the volume of trade, however, show that the sharp appreciation of the yen since September is having the desired effect on trade flows. Compared to year-earlier levels, export volume fell for the fourth consecutive month in June (down 2.3 percent), while import volume rose for the tenth consecutive month. Eventually these volume changes should reduce the dollar value of Japan's trade surplus. Economists estimate that it takes 6 to 18 months for currency changes to reduce trade imbalances.

On a customs clearance basis, the dollar value of Japanese exports rose 20 percent during the first half of 1986 from the year-earlier level, while imports fell slightly, doubling the trade surplus to $34.2 billion (see

Table 2). The surplus with the United States was $23.1 billion (compared to $16.8 billion in the first half of 1985), while the surplus with the European Community was $8.3 billion (compared to $4.8 billion). Lower oil prices cut Japan's deficit with the Middle East to $5.9 billion in the first half of 1986, compared to $9.6 billion during the same period a year earlier.

Table 2: Japan's Exports and Imports in Dollar Terms

(in millions of dollars)

Year	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1981	$152,030	17.1%	$143,290	2.0%	$8,741
1982	138,831	-8.7	131,931	-7.9	6,900
1983	146,928	5.8	126,393	-4.2	20,534
1984	170,114	15.8	136,503	8.0	33,611
1985	175,638	3.2	129,539	-5.1	46,099
1985:I	38,503	-1.3	32,513	-5.7	5,990
1985:II	43,748	0.6	32,094	-7.0	11,654
1985:III	43,909	2.7	31,239	-8.0	12,671
1985:IV	49,478	10.3	33,693	0.5	15,784
1986:I	45,520	18.2	33,060	1.7	12,460
1986:II(p)	53,154	21.5	31,447	-2.0	21,707

Source: Japan Tariff Association

Table 3: Japan's Exports and Imports in Yen Terms

(in billions of yen)

Year	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1981	Y33,469	13.9%	Y31,464	-1.7%	Y2,005
1982	34,433	2.9	32,656	3.8	1,776
1983	34,909	1.4	30,015	-8.1	4,895
1984	40,325	15.5	32,321	7.7	8,004
1985	41,956	4.0	31,085	-3.8	10,871
1985:I	9,898	9.5	8,340	4.3	1,559
1985:II	11,025	11.0	8,093	2.8	2,932
1985:III	10,591	2.4	7,534	-8.2	3,057
1985:IV	10,442	-5.3	7,118	-13.5	3,324
1986:I	8,678	-12.3	6,345	-23.9	2,333
1986:II(p)	9,117	-17.3	5,403	-33.2	3,714

Source: Japan Tariff Association

The yen value of Japanese exports fell 15 percent in the first six months of 1986, but the trade surplus continued to rise as a result of a 28.5 percent contraction in imports (see Table 3). Declining purchases from Middle East countries accounted for more than one-third of this drop. The surplus with the United States, though, fell in yen terms, reflecting an 11.6 percent decline in shipments to this country.

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Yen Approaches Y150=$1.00 Level

Continued pessimism about the outlook for the U.S. economy helped the yen soar to new heights last week, reaching a postwar record of Y152.8=$1.00 August 4. The latest surge left the yen 58 percent above its level prior to the September 22, 1985 five-nation agreement to lower the value of the dollar.

Most analysts blame the decline in the dollar on the steady stream of negative economic reports coming out of Washington, leaving foreign investors and central banks disenchanted with holding dollars. Recent indicators do not point to an acceleration of the 2.4 percent real economic growth rate registered in the first half of the year. News that the June trade figures showed the U.S. trade deficit running at $170 billion annually also reduced confidence in the dollar. Another factor was the July 30 speech by Secretary of State George Shultz, who suggested that the Reagan administration expects further declines in the U.S. currency.

Finance Minister Kiichi Miyazawa, who believes the yen should return to the Y160 to Y170 range, announced his ministry is considering relaxing the remaining controls on capital outflows. Increased overseas investment would strengthen the dollar by promoting the sale of yen for dollars. Long-term capital outflows in the first six months of 1986 totaled $48.1 billion compared to $27.5 billion during the same period of 1985.

One specific proposal being considered by MOF is an increase in the limit on purchases of foreign bonds and other securities by insurance companies and trust banks. This proposal is typical of the financial liberalization pattern of the past 10 years; restrictions on capital inflows are lowered during periods of a weak yen and outflows are encouraged when the yen rises.

Bank of Japan governor Satoshi Sumita agreed that the relaxation of controls on capital outflows would be an effective way to slow the yen's appreciation. Although large-scale intervention, estimated at $1 billion on August 4 alone, has failed to stabilize the yen, Mr. Sumita said that the central bank will continue to intervene in exchange markets. Despite the strength of the yen, the central bank governor said that he has no plans to further lower the official discount rate. Three cuts already this year have reduced it to the historically low level of 3.5 percent. Mr. Sumita said that surging land and stock prices are partly a result of relaxed credit conditions and require close monitoring.

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Update On Financial Liberalization In Japan

Although Tokyo listed only one step toward financial liberalization in its report on implementing the 1985 action program (see article in this issue), the Ministry of Finance continues to make incremental changes in financial rules and regulations. The cumulative impact of these changes cannot be ignored, especially since U.S. debt financing needs have not diminished and the value of the yen has continued to rise gradually against the dollar.

MOF announced a new round of moves July 19 to liberalize interest rates paid on deposits. Effective September 1 the minimum time deposit on which market-determined interest rates will be paid will be lowered from Y500 million ($3.1 million at Y160=$1.00) to Y300 million ($1.9 million). As part of its financial reform program, Tokyo agreed in 1984 to liberalize interest rates. Free-market rates on large deposits were initiated October 1, 1985, with large defined as a minimum of Y1 billion ($6.3 million). MOF dropped this floor for

No Turnaround Likely In U.S. Trade Deficit Until 1987

Eighteen months after the dollar peaked on foreign exchange markets there are still few signs that the quarterly U.S. trade deficit has bottomed out (see Table 1). While Reagan administration trade policymakers and business economists alike had warned that a turnaround would take time because of the perverse initial impact of the dollar's depreciation (the J-curve effect), past experience indicated that at the outside, the weaker dollar should begin to influence trade flows no later than 1986's second half. With imports (c.i.f.) outrunning exports at an annual rate of $167.8 billion at mid-year, however, analysts are now predicting that the trade deficit, which ballooned to $148.5 billion in 1985, will not contract until 1987 at the earliest.

Why the backpedaling? The reasons are starting to have a familiar ring. Although the dollar has plunged in value against Japan's yen and the currencies of West Germany, the United Kingdom, France and Italy over the last 18 months, it has held its ground or even appreciated against the currencies of the other five countries that make up the list of the top ten U.S. trading partners. The dollar is up roughly 2.5 percent against the currency of Canada, the biggest U.S. export market and the number-two import supplier behind Japan, and by a huge margin against the currency of Mexico, the third-largest U.S. trading partner. And with the Taiwanese dollar, Korean won and Hong Kong dollar moving in synch with this country's dollar, another 6 percent or so of U.S. exports and 10 percent-plus of U.S. imports remain unaffected by the dollar's depreciation.

What's more, the benefits of the lower dollar have not yet shown up in the U.S. trade results with Japan and Europe (see Table 2). Slow growth abroad continues to put a damper on demand for American-supplied manufactures and industrial and agricultural inputs. At the same time, Japanese and European manufacturers are in no rush to hike prices on their U.S.-bound exports, having decided to sacrifice short-term profits for market share. The money foreign competitors earned in the American market by not cutting export prices during the period of the strong dollar gives them the flexibility to pursue this sales strategy. Moreover, the declining dollar plus the fall in world oil prices gives Japanese and European producers some help on the cost side.

At first glance the data on trade with Japan through June (see Table 3) would seem to undermine the argument that the weaker dollar has had no impact on U.S. export and import numbers. After all, sales to Japan were up 13.2 percent to $13.1 billion after slipping 0.3 percent in 1985's first half. But a closer look at the export figures (see Table 4) reveals that all of this gain and then some resulted from transshipments of foreign gold through the United States to Japan. Adjusting for these shipments, exports were off by a bigger margin in the first six months of 1986 than in the year-earlier period.

The slowdown in the expansion of imports from Japan is similarly deceptive. Most of the cutback in the growth rate from 25.2 percent in the first half of 1985 to 16.7 percent this year reflected a big drop in arrivals of steel mill products as a result of the administration's import restraint program. A few other big-ticket items were in the minus column (see Table 5), but gainers outnumbered losers by a huge margin. More significantly, larger volume played a bigger role in the advance of imports to $41.8 billion (c.i.f.) than higher prices, a quick survey of major products indicates. The one exception was cars, which jumped 31.4 percent to $9.8 billion on a 9.7 percent shipment

Table 1: Total U.S. Trade

(in millions of dollars)

	Exports (f.a.s.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985: I	$56,146	4.4%	$87,521	5.6%	$-31,375
1985: II	54,322	-1.1	92,216	9.1	-37,894
1985: III	50,345	-5.5	88,683	-2.3	-38,338
1985: IV	52,333	-6.4	93,207	12.4	-40,874
1986: I	53,654	-4.4	97,125	11.0	-43,471
1986: II	54,465	0.3	94,914	2.9	-40,449

Table 2: U.S. Trade Balance With Top Ten Trading Partners

(in millions of dollars; exports, f.a.s., imports, c.i.f.)

	1985	January-June 1985	January-June 1986
Total	$-148,480	$-69,268	$-83,921
1. Canada	-22,176	-10,523	-11,775
2. Japan	-49,749	-24,235	-28,702
3. Mexico	-5,757	-2,629	-2,513
4. West Germany	-12,182	-5,798	-7,709
5. United Kingdom	-4,300	-1,127	-2,322
6. Taiwan	-13,061	-6,511	-7,077
7. Korea	-4,757	-1,909	-3,082
8. France	-3,864	-1,943	-1,857
9. Italy	-5,756	-2,481	-3,075
10. Hong Kong	-6,208	-2,661	-2,771

Table 3: U.S. Trade With Japan

(in millions of dollars)

	Exports (f.a.s.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1985: I	$6,252	9.8%	$17,373	26.4%	$-11,121
1985: II	5,298	-10.1	18,413	24.1	-13,115
1985: III	5,514	-5.5	18,216	5.9	-12,702
1985: IV	5,567	-9.6	18,379	25.9	-12,812
1986: I	5,574	-10.8	20,888	20.2	-15,315
1986: II	7,499	41.5	20,886	13.4	-13,387

Table 4: U.S. Exports to Japan

(in millions of dollars, f.a.s. value basis)

	January-June 1985	January-June 1986	Percent Change
Total Exports	$11,550.1	$13,072.2	13.2%
Industrial Supplies	4,449.5	4,122.0	-7.4
Bituminous Coal	418.7	325.4	-22.3
Petroleum Products	392.8	280.6	-28.6
Natural Gas	115.0	98.7	-14.2
Nuclear Fuels	55.9	23.8	-57.4
Logs and Lumber	430.8	493.3	14.5
Paper Base Stocks	242.8	254.9	5.0
Paper and Paper Products	140.5	166.8	18.7
Organic Chemicals	354.3	371.4	4.8
Inorganic Chemicals	401.8	394.5	-1.8
Plastics and Synthetic Resin Compounds	156.7	155.9	-0.5
Manufactured Fertilizers and Insecticides	113.0	138.7	22.7
Steel Scrap	97.2	124.4	28.0
Nonferrous Ores and Scrap	227.7	241.9	6.2
Nonferrous Metals	167.2	104.8	-37.3
Textiles	61.3	57.8	-5.7
Raw Cotton	269.3	96.3	-64.2
Hides and Skins	136.4	164.0	20.2
Leaf Tobacco	83.4	74.0	-11.3
Capital Goods	3,223.0	3,022.0	-6.2
Nonelectric Machinery	1,828.8	1,689.5	-7.6
Data Processing Equipment	731.3	656.7	-10.2
Measuring, Testing and Control Instruments	244.8	220.7	-9.8
Laboratory Testing and Control Instruments	57.4	49.4	-13.9
Scientific, Professional and Medical Equipment	138.3	156.6	13.2
Power Generating Equipment (excl. aircraft and automotive engines)	40.5	37.7	-6.9
Metalworking Equipment	56.3	76.1	35.2
Service Industry Equipment	61.1	65.8	7.7
Electric Machinery	433.9	436.9	0.7
Generators and Transformers	37.5	38.0	1.3
Broadcast and Communications Equipment	179.0	180.6	0.9
Telephonic and Other Electric Equipment	217.5	218.3	0.4
Transportation Equipment	960.3	895.6	-6.7
Civilian Aircraft	542.0	410.1	-24.3
Civilian Aircraft Engines and Parts	276.7	309.1	11.7
Automotive Parts	98.1	109.6	11.7
Food and Feed	2,306.6	2,344.3	1.6
Corn	686.0	475.2	-30.7
Sorghum	105.4	78.1	-25.9
Soybeans	466.1	447.6	-4.0
Wheat	226.8	231.3	2.0

Fruits and Vegetables	244.4	287.5	17.6
Meat and Meat Products	255.6	351.1	37.4
Fish and Fish Products	145.3	232.7	60.2
Consumer Goods	737.8	790.3	7.1
Pharmaceuticals	310.4	327.2	5.4
Toys and Sporting Goods	43.4	44.2	1.8
Cigarettes	40.3	53.0	31.5

Table 5: U.S. Imports from Japan

(in millions of dollars, Customs value basis)

	January-June 1985	January-June 1986	Percent Change
Total Imports	$33,967.8	$39,960.1	17.6%
Automotive Products	11,743.6	15,728.3	33.9
Cars	7,488.3	9,837.0	31.4
Trucks	2,084.3	2,868.2	37.6
Automotive Parts	2,166.7	3,015.4	39.2
Capital Goods	10,967.8	12,332.0	12.4
Nonelectric Machinery	7,418.1	8,365.9	12.8
Business Machines	3,303.1	3,734.3	13.1
Metalworking Machinery	630.9	665.1	5.4
Agricultural Machinery	192.4	266.7	38.6
Specialized Industrial Machinery	631.7	763.8	20.9
Scientific, Professional and Medical Equipment	292.3	409.4	40.1
Electric Machinery	3,375.4	3,688.5	9.3
Transportation Equipment	174.3	277.6	59.3
Consumer Goods	6,908.5	7,644.2	10.6
Video and Audio Recorders and Players and Stereo Equipment	2,662.3	2,930.2	10.1
Television Sets	376.4	447.4	18.9
Radio Receivers	157.9	119.5	-24.3
Tableware and Glassware	206.9	218.8	5.8
Metal Cookware and Cutlery	190.1	224.7	18.2
Photographic and Optical Goods	470.0	545.2	16.0
Clocks and Watches	230.3	226.4	-1.7
Toys and Sporting Goods	264.9	246.4	-7.0
Motorcycles and Parts	472.0	519.3	10.0
Clothing	238.0	234.9	-1.3
Intermediate Goods	3,752.4	3,610.8	-3.8
Steel Mill Products	1,731.6	1,270.3	-26.6
Nonferrous Metals	263.3	264.9	0.6
Organic Chemicals	298.3	361.3	21.1
Textiles	358.7	438.3	22.2

gain to 1.3 million vehicles. Otherwise, the relationship held. Trucks, for example, were up 29.6 percent in volume to 515,400 units and 37.6 percent in value to $2.9 billion, while a 7.5 percent rise in deliveries of video cassette recorders to 8.4 million units translated into a sales gain of just 2 percent to $2.1 billion.

Susan MacKnight

Notes

- Amid renewed charges from U.S. steel industry executives and congressional steel caucus members that President Reagan's September 1984 plan to contain the market inroads of foreign steel is a flop, Japan has agreed to cut 1986 U.S.-bound steel exports as compensation for exceeding its quota during the first 15 months of the restraint program. Under an arrangement finally hammered out July 20 by the Commerce Department and the Ministry of International Trade and Industry, Japan will "pay back" the overshipments by reducing this year's ceiling on exports of finished steel (sheet and strip, plate, structural shapes, bars, pipe and tubing, and wire and wire rod) plus fabricated structural products and semi-finished steel to 4.1 million metric tons from an originally projected 4.6 million metric tons. Nearly half of the cutback fell on pipe and tubing; the quota on these products dropped by 245,000 metric tons to 438,000 metric tons. Roughly 117,000 metric tons were deducted from the restraint level for structural shapes, reducing it to 572,000 metric tons, while the limit on sheet and strip was trimmed by 103,000 metric tons to 2,377,000 metric tons. Small adjustments were made in the quotas on wire and wire rod (373,000 metric tons for 1986), bars (180,000 metric tons), and plate (16,000 metric tons) as well as in the shipment caps on welded H beams and other fabricated structural products (101,000 metric tons) and semi-finished steel (62,000 metric tons).

With an already long list of outstanding bilateral trade problems, Tokyo did not want the overshipment issue to turn steel into the latest U.S.-Japan dispute. At the same time, though, MITI officials were reluctant to bow to U.S. demands for an offset in 1986 exports since they are convinced that Japanese steel mills have been unfairly forced to shoulder the brunt of the Reagan administration's crackdown on steel imports. Ministry spokesmen have long complained that although Japan agreed in March 1985 to a five-year cap on shipments retroactive to October 1984 (see JEI Report No. 11B, March 22, 1985), the European Community avoided renegotiating its 1982 export-restraint arrangement with the United States until November 1985 and then held out for a January 1, 1986 starting date. They are equally irked by the fact that Japan agreed to reduce its target share of U.S. finished steel consumption to 5.8 percent from a five-year average of 6.3 percent, while the EC's market participation was trimmed by just 0.1 percentage point to 5.6 percent. The fact that Canadian steel remains unregulated is another sore point, especially since Canada's market share continues to edge up.

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A NEW ERA FOR U.S. AGRICULTURAL EXPORTS

Summary

U.S. agricultural exports are reeling. Already down $8.8 billion in 1985 to $29 billion, overseas farm sales are expected to slide another $4 billion or so this year. Shipments to Japan, the dominant export market, have no more weathered the slump than sales to other traditional U.S. customers, falling 20.2 percent last year alone to $5.4 billion. If anything, the drop in Japan's purchases provides the best illustration of why U.S. agricultural exports are in trouble. It also highlights the shortcomings of the programs now being pushed on Capitol Hill to deal with the crisis in farm sales abroad.

What Has Happened to U.S. Farm Exports?

In 1981 U.S. agricultural exports hit $43.3 billion, nearly double overseas sales five years earlier. By 1985 farm shipments to foreign customers had tumbled to just $29 billion (see Table 1). What had already been tagged the agricultural export crisis is earning that label this year since American farmers will be lucky if 1986 export sales stay above $25 billion. And that might not be the decade's low point.

Why has the U.S. agricultural export boom turned into a slump? There is no shortage of explanations: the strong dollar, domestic farm policies, aggressive competition from traditional foreign exporters and newcomers alike, expanded food production in countries that used to be big importers, financial constraints in commodity-dependent developing countries -- the list goes on. But sorting out the primary causes of the tailspin from supporting or temporary factors first requires a quick look back at the export boom of the late 1970s.

Table 1: U.S. Agricultural Trade, 1976-86

(in millions of dollars)

	Exports (f.a.s.)	Imports (Customs)	Trade Balance
1976	$22,978	$10,966	$12,012
1977	23,636	13,438	10,198
1978	29,382	14,805	14,577
1979	34,749	16,724	18,025
1980	41,233	17,366	23,867
1981	43,339	16,772	26,567
1982	36,627	15,341	21,286
1983	36,099	16,627	19,472
1984	37,804	19,334	18,470
1985	29,026	19,968	9,058
January-June			
1985	15,580	10,494	5,086
1986	13,044	10,976	2,068

World economic conditions were tailor-made for an enormous expansion in U.S. agricultural exports. Moderate to strong economic growth in Europe, Japan and Canada plus rapidly rising export earnings in developing countries -- whether oil producers such as Mexico, Venezuela and Saudi Arabia, suppliers of other industrial inputs, or new exporters of manufactured products like Korea, Taiwan and Brazil -- added up to steady annual gains in international demand for food and feed. Stagnant grain output in Eastern Europe during the second half of the 1970s as well as periodic crop shortfalls in the Soviet Union also lifted world market demand; so did China's emergence as a major grain importer.

While Argentina, Australia, Canada and other competitors increased sales to their traditional customers in the late 1970s, only the United States with its huge production capabilities, diversified commodity base and well-developed export infrastructure was in a position to respond quickly to the boom in world demand. And respond it did. With an extra assist from the weak dollar, the volume of U.S. agricultural exports climbed by more than two-fifths in the four years through 1980 before leveling off the next year. But that was not the end of the story. Farm prices soared in the late 1970s and the first two years of the 1980s in tandem with the general run-up in world commodity prices, doubling the impact of bigger volume on this country's agricultural export numbers.

A glance at what happened to overseas sales of wheat, corn and soybeans -- the source of roughly half of U.S. farm export earnings -- puts the magnitude of the export boom in better perspective (see Table 2).

- Wheat shipments expanded by two-thirds (17.4 million metric tons) between 1976 and 1981 to 43.9 million metric tons, and with prices up by one-third, sales doubled to $7.8 billion. China, which only became a U.S. wheat customer in 1978, drove the market, alone buying 7.4 million metric tons in

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1981, although sales to the Soviet Union did zigzag up over this period from 1.7 to 4.1 million metric tons.

- The gain in corn exports was only slightly less dramatic as sales soared by close to two-thirds to a 1980 peak of $8.5 billion on a volume jump of over two-fifths (18.8 million metric tons) to 63 million metric tons. Here a different group of customers were the major market-movers: Japan, which upped purchases from 6.4 million metric tons in 1976 to 11.8 million metric tons four years later; Eastern Europe, which added 4.5 million metric tons for a 1980 total of 7 million metric tons; and Mexico, which boosted imports from just 0.7 million metric tons in 1976 to 4.9 million metric tons.

- By the time soybean exports topped out in 1982, sales had shot up by almost nine-tenths to $6.2 billion and shipments had climbed by two-thirds (10.1 million metric tons) to 25.5 million metric tons. Behind this jump were bigger purchases by Spain -- an extra 2 million to 3.2 million metric tons -- and the Netherlands -- 1.8 million more for a 1982 tally of 5.2 million metric tons -- plus larger shipments to Japan, which increased deliveries from 1976's 3.1 million to 4.1 million metric tons.

Table 2: U.S. Exports of Wheat, Corn and Soybeans, 1976-86*

	Quantity (in thousands of metric tons)			Value (in millions of dollars)		
	Wheat	Corn	Soybeans	Wheat	Corn	Soybeans
1976	26,527	44,264	15,332	$3,879	$5,194	$3,316
1977	23,826	40,415	16,196	2,700	4,100	4,393
1978	34,096	50,043	20,705	4,335	5,258	5,208
1979	33,384	59,179	20,890	5,265	6,977	5,701
1980	35,750	63,042	21,779	6,375	8,492	5,880
1981	43,908	54,746	21,830	7,844	7,935	6,186
1982	40,782	48,789	25,475	6,676	5,582	6,218
1983	38,469	47,529	22,704	6,235	6,367	5,913
1984	42,243	48,940	19,483	6,473	6,999	5,419
1985	24,804	43,932	16,888	3,607	5,190	3,732
January-June						
1985	12,580	24,205	8,558	1,903	3,037	1,991
1986	10,621	13,724	11,756	1,448	1,522	2,458

*Includes wheat and corn donated for relief.

A review of sales by country also provides a handle on the extent of the export boom. Already the top U.S. buyer in 1976, Japan almost doubled its purchases over the next five years to $6.6 billion. Only a step behind was the number-two market, the Netherlands, which transships large volumes of American grains and oilseeds to other West European countries as well as to Eastern Europe, the Soviet Union and Africa. But the most striking market development of the late 1970s was the emergence of major new customers for American farm commodities. China, for example. From ground zero in 1976, China had become the sixth-largest buyer by 1981 with purchases of $2 billion. Equally arresting, sales to Mexico soared from under $0.4 billion to $2.4 billion -- a total that made it the number-three export market. Korea also jumped several spots in the rankings to fifth place as its purchases climbed by $1.2 billion to $2 billion.

Major foreign buyers obviously could not sustain gains like these indefinitely, particularly with the dollar again strengthening in value. But instead of a soft landing, the export boom ended with a thud in 1982 -- a casualty of the recession that engulfed developed and developing countries alike that year. And in a double blow to the export numbers, prices reversed course, pulled down by all-time-high wheat production in 1981, a then-record 1981 corn crop and mounting surpluses of most other commodities.

Although exports dropped 15.5 percent in 1982 to $36.6 billion, the contraction could have been much deeper. A short soybean crop in Brazil, this country's main competitor for world trade in soybeans and soybean meal, gave the United States additional sales in countries that normally buy part of their requirements from Brazil. A more favorable soybean meal-corn price relationship in the European Community, the destination for about three-fifths of U.S. soybean and soybean meal exports, also lifted sales. Wheat exporters got some help from China and the Soviet Union, which maintained their purchases close to 1981 levels, as well as from India, which bought a large volume of U.S. wheat to make up for small food grain crops. Similarly, the fall in corn shipments was braked by bigger purchases by the Soviet Union, Spain and Korea.

A series of breaks in 1983 again insulated the agricultural trade numbers from the harsher realities of the new world market conditions. Through the first half of the year, however, it looked like exporters were in for a rude awakening: prices continued to fall under the weight of another record-breaking corn crop in 1982 and near-record 1982 production of wheat and soybeans, while demand for food and feed here and abroad showed no signs of rallying. But then nature intervened in the form of a severe drought during the summer of 1983. Coming on top of the government's payment-in-kind output reduction program for corn, the drought cut the 1983 corn crop in half and drove prices back to their 1981 level. The story was much the same for soybeans as the drought reduced 1983 production by one-fourth and returned prices to their former highs. In addition, overbuying by Japanese oilseed crushers worried that the drought might lead to tighter supplies and higher prices than actually materialized contained the drop-off in soybean shipments. For its part, corn export volume held up better than expected since a second year of drought in South Africa limited competition for U.S. deliveries to the big combined market of Japan, Korea and Taiwan. Meanwhile, expanded purchases by India, Iraq, Morocco and the Soviet Union propped up wheat exports. The net result: U.S. agricultural exports only slipped 1.4 percent in 1983 to $36.1 billion.

Any doubts that American exporters were on a lucky streak evaporated in 1984 when overseas farm sales expanded 4.7 percent to $37.8 billion on generally higher volume despite the strong dollar, relatively firm export prices, increased production outside the United States and a small gain in non-U.S. food and feed demand. Wheat and corn shipments reached their highest levels since 1981, thanks in large part to big Soviet purchases in the wake of another shortfall in grain production. With supply problems in Argentina, the main competitor for the U.S.S.R.'s grain trade, the United States provided almost all of the Soviet Union's expanded import requirements, including what was then an all-time-high volume of corn and a near-record amount of wheat. Wheat shipments were also buoyed by stepped-up sales to China, Morocco and Turkey, while a sizable increase in sales to drought-stricken South Africa ironically gave an extra boost to corn shipments.

World market conditions finally caught up with U.S. agricultural exports last year, slicing sales by an unprecedented $8.8 billion to $29 billion and reducing the volume of wheat, corn and soybean shipments to levels not seen since the mid-1970s. Wheat and coarse grain consumption outside the United States, which had staged an unusually weak comeback during the first two years of the global economic recovery, slipped in 1985, while soybean meal and oil usage, although up in Latin America, East Asia and the Soviet Union, fell in the pivotal European Community market. By itself, sluggish international grain and soybean demand spelled trouble for American farm sales abroad in 1986 -- a factor generally overlooked in popular treatments of the export contraction. But, in fact, U.S. grain exporters were hobbled by a double constraint: another increase in wheat and coarse grain production by consistently big American customers and occasional buyers alike.

Lower world import requirements took a particularly heavy toll on wheat shipments. In a one-two punch, sales to the Soviet Union, the top export market in both 1983 and 1984, dropped 6.6 million metric tons and deliveries to China, 1984's second-largest buyer and the biggest U.S. wheat customer during the 1980-82 period, fell 3.2 million metric tons. To make matters worse, two other traditional importers -- Japan and Brazil -- plus Tunisia, Bangladesh, Indonesia and several more countries that were swing buyers in 1984 trimmed purchases because of improved harvests.

Although short Russian coarse grain supplies boosted corn shipments by 2.4 million metric tons in 1985 to a record 13.1 million metric tons, increased production of feed grains elsewhere in the world cost U.S. corn exporters sales. Nearly 2.3 million metric tons were lost when improved weather conditions allowed South Africa to supply most of its own coarse grain needs. Likewise, another increase in Mexican production led to an additional 1.1 million metric tons cutback in American exports. But far more damaging to U.S. export prospects than either of these development was last year's near-peak grain harvest in Western Europe. Coming on the heels of record production in 1984, the big crop not only reduced European import requirements but turned the EC into a net exporter of coarse grains for the first time.

The combination of flat international demand for grains and soybeans and greater output in importing countries made sales more difficult for all exporters in 1985, but the United States was the big loser in the fight for world market share for the fifth straight year (see Table 3). American wheat suppliers, which lost an incredible 17.4 million metric tons in exports between poor market conditions and heavy competition, saw the EC basically take over Morocco's large trade as well as split the bulk of sales to Turkey with Argentina. Argentine wheat also displaced most American wheat in Peru and won a bigger share of Brazil's reduced import requirements. Moreover, part of the huge cutback in U.S. shipments to the Soviet Union reflected expanded Russian purchases from Argentina, the EC and Australia, while some of the drop in China's imports can be traced to higher Australian sales.

Despite the EC's new status as a net exporter of coarse grains, it was competition from a true newcomer to the world feed grain market -- China --

Table 3: World Exports of Wheat, Corn and Soybeans, 1981-86*

(in millions of metric tons)

	1981/82	1982/83	1983/84	1984/85	Projected 1985/86
Wheat and Wheat Flour					
Canada	17.6	21.4	21.8	19.4	17.5
Australia	11.0	8.1	10.6	15.3	15.7
Argentina	4.3	7.5	9.7	8.0	6.1
European Community	15.5	16.3	15.5	17.8	16.0
Others	4.1	5.5	5.6	7.5	6.3
Total Non-United States	52.5	58.8	63.1	68.0	61.6
United States	48.8	39.9	38.9	38.1	26.0
World Total	101.3	98.7	102.0	106.1	87.6
U.S. Share	48.2%	40.4%	38.1%	35.9%	29.7%
Corn					
Argentina	4.9	6.5	5.9	7.0	9.5
South Africa	4.7	2.3	0.1	0.5	1.4
Thailand	3.3	2.1	3.0	3.0	3.5
China	0.1	0.1	0.4	5.2	4.0
Others	4.3	5.0	3.7	4.0	3.6
Total Non-United States	17.3	15.9	13.1	19.7	22.0
United States	50.0	47.5	47.4	46.7	36.1
World Total	67.3	63.4	60.5	66.4	58.1
U.S. Share	74.3%	74.9%	78.4%	70.3%	62.1%
Soybeans					
Brazil	0.9	1.3	1.6	3.5	1.5
Argentina	1.9	1.4	3.0	3.3	2.9
Paraguay	0.8	0.6	0.4	0.8	0.5
China	0.1	0.3	0.7	1.1	0.9
Others	0.4	0.3	0.2	0.3	0.3
Total Non-United States	4.0	3.9	5.9	8.9	6.0
United States	25.3	24.6	20.2	16.3	21.2
World Total	29.3	28.6	26.1	25.2	27.3
U.S. Share	86.4%	86.0%	77.4%	64.7%	77.7%
U.S. Share of World Wheat, Corn and Soybean Exports	62.7%	58.7%	56.5%	51.1%	48.2%

*Trade years as follows: wheat, July-June; corn, October-September; soybeans, October-September.

that cost this country the largest volume of corn sales in 1985. And adding insult to injury, the losses came in the biggest U.S. export market -- East Asia, where Chinese corn replaced 2.4 million metric tons of American corn in the stable Japanese market and an estimated 0.9 million metric tons in the expanding Korean market. U.S. corn shipments to the region were also undercut by increased Argentine competition, but a more important sales constraint was Korea's substitution of nearly 1 million metric tons of Australian and Canadian feed wheat for corn. A problem for American exporters in some other areas of the world as well, the availability of large volumes of feed wheat was just one more cause of the 5 million metric ton drop in 1985 corn shipments.

The United States also ceded ground to competitors in the expanding East Asian soybean market -- in this case to Brazil and Paraguay. The major battle for soybean sales, however, was played out in the flat markets of Western and Eastern Europe, and here, too, Brazilian suppliers made inroads at the expense of American exporters, as did Argentine shippers. Still, there was a thin silver lining to the U.S. loss of world market share -- an increase in sales to East Asia and a few European countries that limited the drop in 1985 soybean exports to 2.6 million metric tons.

Why has the United States had to shoulder a disproportionate share of the adjustment dictated by declining world trade in grains and soybeans? The reflex answer is the European Community's agricultural export subsidies. This finger-pointing is on target to the extent that it identifies one cause of the falling U.S. share of the world wheat market. Otherwise, it misses the mark. EC member countries are basically swing suppliers of coarse grains. Moreover, they do not export soybeans or competing oilseeds, and their sales of soybean meal and oil are no higher now than at the start of the 1980s.

The other obvious candidate is that the formerly strong dollar gave a big edge to U.S. competitors, but this explanation also has its limitations. For example, while the dollar's appreciation during the first half of the 1980s benefited Australian grain exporters, it had a limited impact on the price competitiveness of Canadian wheat since the Canadian dollar generally moved in line with the U.S. dollar. Similarly, EC exporters gained little benefit from the strong dollar because it merely raised U.S. grain prices closer to the high European level. Analysts also argue that the overvalued dollar was probably a minor factor behind the expanded world market presence of Argentina, Brazil and other developing-country grain and oilseed competitors.

In fact, the major cause of U.S. agriculture's declining world market share lies closer to home: domestic farm policy. Designed to maintain farmers' income, the system of government price supports, stockpiling programs and production controls has the added effect of keeping U.S. agricultural prices above market levels (see Table 4). This premium did not handicap American exporters during the world agricultural trade boom of the late 1970s. In the buyers' market of the mid-1980s it does.

The Sales Slide and Japan

Sluggish food and feed demand, expanded output in importing countries and stiff foreign competition took their toll on 1985 U.S. agricultural exports to every major customer from number-one Japan on down (see Table 5). Sales to

Table 4: Wheat, Corn and Soybean Prices, 1981-86*

(in dollars per metric ton, f.o.b. vessel, Gulf ports)

	Wheat	Corn	Soybeans
1981 Average	$176	$135	$272
1982 Average	161	110	233
1983 Average	158	137	269
1984 Average	153	138	271
1985 Average	137	114	214
1981 January	191	155	299
April	181	146	297
July	170	141	281
October	170	117	248
1982 January	175	109	247
April	171	120	250
July	152	113	241
October	149	94	201
1983 January	166	109	225
April	168	134	242
July	148	141	251
October	154	149	320
1984 January	153	144	292
April	158	150	303
July	149	143	257
October	154	123	236
1985 January	149	121	231
April	146	122	231
July	130	117	215
October	129	100	186
1986 January	133	108	210
April	138	102	205
July	128	n.a.	n.a.

*Wheat prices: No. 2, hard winter, ordinary protein; corn prices: No. 3 yellow; soybean prices: No. 2 yellow.

Japan, which had bucked 1983's decline in overseas farm sales and outperformed the market in 1984, slid 20.2 percent to $5.4 billion, the lowest level in six years. While this drop fell short of the overall export decline, Japan is the ideal case study for isolating the impact of competition on U.S. corn and soybean shipments from the twin sales constraints of weak demand and bigger domestic harvests; Japanese production of livestock and poultry feed continued to expand in 1985 and local output of coarse grains and soybeans remained negligible.

Table 5: U.S. Agricultural Exports by Major Market, 1981-85*

(in millions of dollars)

		1981	1982	1983	1984	1985
Total		$43,339	$36,627	$36,099	$37,804	$29,026
1.	Japan	6,606	5,555	6,251	6,782	5,409
2.	U.S.S.R	1,685	1,866	1,473	2,878	1,908
3.	Netherlands*	3,391	3,085	2,576	2,323	1,870
4.	Canada	2,058	1,820	1,844	1,963	1,622
5.	Mexico	2,432	1,156	1,942	1,993	1,439
6.	Korea	2,008	1,582	1,840	1,650	1,412
7.	Taiwan	1,145	1,155	1,308	1,458	1,231
8.	West Germany	1,778	1,448	1,529	1,065	944
9.	Egypt	1,002	803	970	909	891
10.	Spain	1,572	1,681	1,207	1,029	831
11.	Italy	1,261	989	731	806	670
12.	Venezuela	895	671	665	783	638
13.	United Kingdom	989	915	823	754	604
14.	Brazil	715	526	479	508	470
15.	Portugal	764	578	660	698	438
16.	France	628	626	485	507	403
17.	Hong Kong	394	392	357	412	389
18.	Belgium-Luxembourg*	856	906	834	753	387
19.	Saudi Arabia	480	500	445	482	351
20.	Iraq	125	132	343	535	326
	China	1,986	1,505	544	613	157

*Not adjusted for transshipments.

Corn - On paper at least, American corn exporters to Japan should have had no trouble last year duplicating their record-setting 1984 performance of 13.6 million metric tons since all signs pointed to another gain in formula feed production -- the end use for roughly three-fourths of Japanese corn purchases. The strengthening yen on top of falling world grain and soybean prices allowed feed industry price leader Zennoh, a national federation of cooperatives controlling nearly two-fifths of the market, to cut bulk feed prices to their lowest levels since the late 1970s. With declines of 6 to 8 percent in the major cost of production for broiler, egg and milk producers and in the second-biggest cost for hog- and beef-finishing operations, Japanese formula feed demand remained on the upswing, shrugging off the dampening impact of weaker farm prices for pork, poultry meat and milk.

Helped paradoxically by greater output of hog rations and broiler feed, compound feed production expanded by 2.8 percent in 1985 to 25.2 million metric tons. Yet with relative feed grain prices again tilted toward increased sorghum usage, this corn substitute supplied nearly three-fifths of the extra grain volume needed to increase output. Feed mills did use some more corn. At any other time, this business would have automatically gone to American exporters, but 1985 was the year the U.S. stranglehold on Japan's feed corn market was broken. Japanese trading companies make no apologies for buying 1.4 million of the feed industry's 11 million metric ton corn requirements from China or for purchasing 0.4 million metric tons of Argentine corn for mixing. Not only was Chinese corn priced below American corn on a delivered basis, but it had a higher protein content and a lower moisture level.

Although American corn suppliers needed no reminder that their luck had run out, they still got one. South Africa's normally big share of the Japanese market for corn to manufacture sweeteners, starch and other processed corn products was up for grabs again because of a second year of limited exportable supplies. But instead of taking over Japan's 4 million metric ton industrial corn market as they had in 1984, U.S. exporters were forced to split this business two-to-one with their new rivals, the Chinese. As simple arithmetic shows, this double setback cost the United States nearly 2.7 million metric tons in sales and dropped volume to 11 million, the lowest level since 1979.

Soybeans - Higher-than-anticipated Japanese production of commercially mixed feed last year did get U.S. soybean exports back on track sooner than anticipated. Despite a reduction in the 1984 soybean crush -- and a corresponding cutback in imports, Japanese oilseed processors still carried unusually large soybean meal stocks into 1985, mainly because 1984 relative protein meal prices had dictated greater use of fish meal and, to a lesser extent, rapeseed meal in compound feed. Moreover, the prospects for working stocks down in 1985 to a level that would support expanded crushing and larger soybean imports seemed bleak no matter how attractively soybeans were priced. Only a limited gain was initially predicted for feed production, while demand for rapeseed oil was rising.

Much to the relief of U.S. soybean exporters, 1985's sizable increase in formula feed output allowed Japanese oilseed processors to reduce meal inventories ahead of schedule. So did a partial flip in the relative prices of feed ingredients that gave vegetable protein meal an edge on other non-grain inputs. Contrary to preliminary indications, though, rapeseed meal was priced better than soybean meal over the six months starting in April.

With stocks back to manageable levels, processors stepped up soybean crushing and at the same time contracted for more imports. While this turnaround rescued U.S. shipments from back-to-back declines, there was a down side for American suppliers: their monopoly on providing all the soybeans crushed by the Japanese industry was broken by Brazil, which received orders for 0.2 million metric tons -- roughly half of the extra volume purchased in 1985. Still, the additional contracts coming to this country lifted exports to nearly 4.4 million metric tons, second only to 1983's outflow.

Wheat - Japan also provides an example of how changing market conditions affected U.S. wheat export prospects in 1985. But there is a major qualification. The government determines the volume of wheat shipped into the country and the price at which it as well as domestic wheat are resold to flour millers, using this control to try and slow the decline in Japanese rice consumption at the expense of increased demand for wheat. The results of this policy are generally the same: virtually no growth in wheat flour consumption and basically flat wheat imports.

Last year there were slight variations on these results. Bread production actually declined by 2.1 percent, while noodle output, which had been rising at a fairly healthy pace, increased by a scant 0.4 percent -- even though for the second straight year the government hiked the rice resale price but left the wheat resale price unchanged. By itself, this was a bad sign for Japan's wheat suppliers -- the United States, Canada and Australia. In addition, though, the 1985 domestic wheat crop came in at 874,000 metric tons, 18 percent above 1984's bumper harvest. The government therefore pared imports from a record 6 million metric tons to 5.5 million metric tons by reducing purchases across the board, including a 0.2 million-plus cut to 3.1 million metric tons in American wheat.

No Shortage of Proposals

As bad as the U.S. agricultural export numbers were in 1985, they were just a preview of this year's results. With no buyers in the wheat market to replace the Soviet Union, China and Brazil, wheat shipments continue to tumble. Corn shipments are in a free fall, pulled down by reduced import requirements in key markets like the Soviet Union and the EC, Argentina's aggressive efforts to sell its record exportable corn supplies, and a flood of cheap feed wheat. Only soybean exports have staged a turnaround, thanks to drought-reduced production in Brazil.

Coming in an election year -- and one in which control of the Senate is at stake, the nonstop slide in grain exports has reignited the 18-month-old debate in Washington about what should be done to revive overseas farm sales. Congress and the Reagan administration thought they had found the answer in the 1985 farm bill, signed into law December 23. Designed to strengthen the competitive position of U.S. exporters as well as cut federal outlays for agriculture over the next five years, the act lowered price-support loan rates* for wheat and feed grains to bring domestic prices closer to international ones. Basic loan rates were cut for the 1986 marketing year, with annual reductions of 5 percent allowed through the 1990 marketing year. But former Department of Agriculture head John Block, using his authority to trim basic loan rates up to 20 percent a year, reduced the 1986 wheat rate to $2.40 a bushel -- a 27 percent drop from the comparable 1985 figure, while his successor, Richard Lyng, has scaled back the rate for 1987 wheat to $2.28. Similar downward revisions have been made in corn loan rates.

Although the new loan rates are still being phased in, farm state legislators of both parties have already labeled the 1985 act a flop, charging that it has failed to deliver on its underlying promise of an export rebound. There is no congressional consensus on what to do instead -- except something and quickly, but a drive spearheaded by Senate Majority Leader Robert Dole (R, Kan.) to extend a new price-support mechanism called a marketing loan to wheat and corn has attracted considerable backing. Mandated for rice and cotton, the marketing loan program allows exporters to sell at world prices even if those prices are below loan rates; the government simply makes up the difference.

*Loan rates are the rates charged by the government on crop loans extended at harvest time. Farmers put up their crops as collateral and have the option of selling them and repaying the loans or defaulting and forfeiting the crops to the government. Since farmers generally default rather than sell below the loan levels, loan rates are a significant determinant of U.S. export prices.

The attractions of marketing loans are understandable in an election year: rice exports have taken off since the program went into effect April 1, while cotton shipments have already rallied in the few weeks since the August 1 starting date for the new system. But the White House continues to rebuff congressional attempts to get it to use its authority to extend marketing loans to wheat and corn. Officials are convinced that including these two crops in the program would trigger a damaging subsidy war with important allies. The huge cost of underwriting marketing loans for grains is also anathema to an administration committed to reducing federal expenditures for agriculture.

There is also strong bipartisan support on Capitol Hill for a major overhaul of the popularly known export bonus program. Under this scheme, reluctantly initiated by the administration in May 1985, the government provides "bonuses" to foreign buyers in the form of government-owned commodities to match world prices and help U.S. exporters recapture sales lost to subsidized competition. But what Congress envisioned as a broad export-promotion program when it incorporated the plan in the 1985 farm bill has been narrowly interpreted by the Department of Agriculture. The Soviet Union, China and other communist countries were excluded from the start. The list of candidates was further shortened by limiting eligibility to countries targeted for subsidized EC sales.

To date, the Department of Agriculture has generated sales of 4.5 million metric tons of wheat and 1.2 million metric tons of flour plus small amounts of a few other commodities, mainly to the Middle East and North Africa. These limited results in an election year have fueled the congressional drive for an expanded program, a move President Reagan tried to head off with his about-face August 1 announcement that the Soviet Union would be offered subsidized U.S. wheat through September 30.

Other than this concession, the White House has so far refused to bow to congressional demands for immediate action to boost exports. Administration officials counsel patience, arguing that in time the decline in U.S. loan rates will trigger additional sales for American grain exporters. Lower world prices will also force U.S. competitors that expanded output in response to the high prices of the late 1970s to cut back production, they add. This is sound economic advice, but it will not win many votes in November from struggling wheat and corn farmers.

For further information, contact Susan MacKnight.

* * * * * *

The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

JEI Report will not be published September 5, 1986 because of the Labor Day holiday. The next issue will be dated September 12, 1986.

APPENDIX

Table 1: U.S. Exports of Corn, 1983-85*

	Quantity (in thousands of metric tons)			Value (in thousands of dollars)		
	1983	1984	1985	1983	1984	1985
Total	47,509	48,876	43,756	$6,363,933	$6,988,822	$5,171,573
U.S.S.R	3,032	10,615	13,045	404,438	1,450,351	1,540,672
Japan	13,047	13,642	10,977	1,753,335	1,990,200	1,292,583
Taiwan	3,266	2,883	2,967	430,296	426,591	373,528
Spain	2,979	1,733	2,461	393,267	234,721	277,149
Korea	4,074	2,200	1,770	559,678	327,317	209,628
Mexico	4,701	2,688	1,631	643,414	401,779	198,526
Egypt	1,586	1,538	1,524	205,844	222,898	175,944
Portugal	2,188	1,923	1,482	299,795	273,867	172,487
Belgium-Luxembourg**	2,166	1,703	813	291,027	237,586	88,062
Netherlands**	541	619	608	76,732	84,997	73,295
Venezuela	1,130	966	536	154,731	146,513	69,560
Brazil	52	77	553	7,622	11,297	64,183
Algeria	379	475	527	49,008	62,230	59,760

*Excludes corn donated for relief as well as seed and popcorn.
**Not adjusted for transshipments.

Table 2: U.S. Exports of Grain Sorghum, 1983-85*

	Quantity (in thousands of metric tons)			Value (in thousands of dollars)		
	1983	1984	1985	1983	1984	1985
Total	5,280	6,792	6,653	$699,067	$847,395	$736,051
Japan	644	2,233	2,426	84,137	269,095	240,862
Mexico	3,294	2,163	1,733	438,615	283,315	213,510
Venezuela	287	339	930	39,717	42,021	106,204
Sudan	0	21	440	0	2,415	55,052
Israel	441	591	484	54,607	73,644	50,633

*Excludes seed.

Table 3: U.S. Exports of Soybeans, 1983-85*

	Quantity (in thousands of metric tons)			Value (in thousands of dollars)		
	1983	1984	1985	1983	1984	1985
Total	22,704	19,483	16,888	$5,913,386	$5,418,493	$3,731,944
Japan	4,585	4,236	4,375	1,220,163	1,197,534	951,680
Netherlands**	3,789	3,364	2,857	960,359	889,341	638,289
Taiwan	1,375	1,313	1,358	362,647	390,637	321,720
Spain	1,944	1,642	1,195	520,748	439,719	252,646
Mexico	943	1,576	962	234,653	473,637	229,424
Korea	745	660	828	201,200	186,788	185,476
West Germany	1,611	742	847	422,614	197,425	185,043
Italy	595	583	628	154,647	157,095	138,036
Belgium-Luxembourg**	1,111	898	529	286,082	240,932	112,029
Portugal	701	609	518	181,370	162,564	110,533
Israel	436	389	428	99,919	109,444	92,820

*Excludes seed and soybean meal.
**Not adjusted for transshipments.

Table 4: U.S. Exports of Wheat, 1983-85*

	Quantity (in thousands of metric tons)			Value (in thousands of dollars)		
	1983	1984	1985	1983	1984	1985
Total	38,313	42,047	24,313	$6,212,960	$6,445,552	$3,536,142
Japan	3,465	3,377	3,120	589,324	534,445	468,970
Brazil	2,626	2,593	2,043	423,196	400,437	307,992
Korea	1,885	1,974	1,892	304,772	293,819	270,158
Nigeria	1,316	1,617	1,472	214,862	255,857	225,709
Egypt	1,943	1,536	1,640	296,481	211,325	206,101
U.S.S.R	4,836	7,646	1,068	800,584	1,170,847	162,290
Algeria	656	596	844	104,791	98,729	123,028
Philippines	846	714	700	145,448	121,601	115,105
China	2,458	4,067	817	377,686	576,319	105,005
Taiwan	623	654	645	107,086	109,118	99,082
Venezuela	889	817	574	157,841	150,232	98,863
Colombia	571	562	597	92,974	87,496	86,306
Portugal	602	732	625	88,692	108,700	82,319
Iraq	1,137	1,120	532	184,020	170,508	78,182
Italy	485	548	452	81,712	91,201	71,830
Pakistan	256	200	543	39,849	29,096	69,262
Chile	1,016	820	506	159,026	121,383	66,739

*Excludes wheat donated for relief.

Table 5: U.S. Exports of Cotton, 1983-85*

	Quantity (in thousands of metric tons)			Value (in thousands of dollars)		
	1983	1984	1985	1983	1984	1985
Total	1,201	1,497	1,097	$1,817,087	$2,441,370	$1,633,244
Japan	318	363	244	499,933	605,078	368,042
Korea	271	277	249	395,587	453,218	361,446
Taiwan	73	110	93	93,094	157,065	117,422
Italy	27	68	52	40,911	112,486	82,105
Indonesia	61	70	43	97,670	118,966	67,888
U.S.S.R.	45	100	45	72,223	167,407	63,577

*Excludes linters.

Table 6: U.S. Exports of Tobacco, 1983-85

	Quantity (in thousands of metric tons)			Value (in thousands of dollars)		
	1983	1984	1985	1983	1984	1985
Total	238	246	249	$1,461,668	$1,511,067	$1,520,644
Japan	52	42	46	338,480	285,979	302,387
West Germany	26	30	35	150,745	177,857	216,653
Spain	18	24	19	128,650	169,189	135,241
Egypt	10	17	19	40,615	72,862	76,089
Italy	15	14	13	88,928	89,927	74,410
Switzerland	8	12	11	53,300	61,197	65,847
Taiwan	9	11	11	50,732	64,857	60,634

Table 7: Major U.S. Agricultural Exports to Japan, 1983-85

	Quantity (in metric tons)			Value (in thousands of dollars)		
	1983	1984	1985	1983	1984	1985
Total	---	---	---	$6,251,158	$6,782,301	$5,409,105
Corn*	13,046,635	13,641,997	10,977,346	1,753,335	1,990,200	1,292,583
Grain Sorghum*	643,858	2,232,603	2,425,873	84,137	269,095	240,862
Soybeans*	4,585,133	4,235,897	4,375,137	1,220,163	1,197,534	951,680
Alfalfa Meal and Cubes	466,480	427,576	400,494	66,634	60,275	56,812
Dried Beet Pulp	364,829	403,187	326,175	51,382	58,185	43,871
Wheat	3,464,770	3,377,081	3,120,324	589,324	534,445	468,970
Barley	303,143	360,662	138,195	37,369	46,718	14,179
Beef and Veal**	59,645	77,640	82,580	253,475	322,206	350,627
Beef and Veal Offals**	33,624	34,538	36,408	83,948	76,941	76,138
Pork**	34,197	18,908	9,183	117,975	62,138	32,654
Chicken**	63,756	50,823	45,019	87,085	72,085	55,144
Lemons and Limes	120,165	120,130	109,761	74,210	80,447	77,146
Grapefruit	168,546	144,713	107,686	59,668	51,362	51,506
Oranges	89,780	87,286	108,127	51,857	61,977	73,317
Raisins	17,839	16,686	20,263	22,649	18,412	21,969
Frozen Vegetables	82,024	83,531	86,822	61,650	59,525	60,958
Almonds	13,756	14,816	17,020	43,506	48,268	45,342
Cotton***	317,845	363,381	244,110	499,933	605,078	368,042
Tobacco	51,791	41,782	46,269	338,480	285,979	302,387
Whole Cattle Hides****	6,388,331	7,333,641	6,824,464	224,111	305,022	276,077
Inedible Tallow	56,365	40,814	38,404	23,872	19,519	15,989

*Excludes seed.
**Fresh, chilled or frozen.
***Excludes linters.
****Quantity in number of pieces.

Source for Tables 1-7: U.S. Department of Agriculture

Table 8: Japan's Imports of Corn, 1981-85

(in metric tons)

	1981	1982	1983	1984	1985
Total	13,590,484	13,570,851	14,700,900	14,169,620	14,225,106
United States	12,128,449	10,956,001	13,438,302	13,736,803	10,969,579
South Africa	1,429,581	2,398,484	1,030,419	9,674	78,033
China	0	0	0	210,469	2,577,801
Argentina	984	120	29,808	118,123	466,295
Feed Corn	10,375,268	10,316,152	11,010,917	10,273,531	10,203,184
United States	10,265,509	9,945,181	10,978,795	9,967,746	8,310,119
China	0	0	0	165,221	1,388,557
Argentina	884	0	28,778	86,199	410,689
Corn for Industrial Use	3,215,216	3,254,699	3,689,983	3,896,089	4,021,922
United States	1,862,940	1,010,820	2,459,507	3,769,057	2,659,460
South Africa	1,343,876	2,228,717	1,027,525	9,674	78,033
China	0	0	0	45,428	1,189,294

Table 9: Japan's Imports of Grain Sorghum, 1981-85

(in metric tons)

	1981	1982	1983	1984	1985
Total	3,300,854	3,427,768	2,956,832	4,477,957	4,792,798
United States	2,854,701	2,180,117	656,076	1,860,473	2,571,415
Argentina	25,480	834,971	2,189,277	1,613,045	1,265,705
Australia	406,364	409,699	103,290	1,000,212	792,826

Table 10: Japan's Imports of Soybeans, 1981-85

(in metric tons)

	1981	1982	1983	1984	1985
Total	4,196,685	4,343,861	4,994,883	4,515,183	4,909,505
United States	4,021,865	4,196,406	4,646,134	4,180,630	4,345,350
China	113,290	111,912	287,971	307,863	288,572
Brazil	991	0	23,865	0	220,922

Table 11: Japan's Imports of Wheat, 1981-85

(in metric tons)

	1981	1982	1983	1984	1985
Total	5,632,655	5,713,299	5,816,329	5,978,324	5,509,614
United States	3,394,374	3,417,255	3,347,809	3,432,904	3,231,741
Canada	1,351,309	1,308,694	1,485,708	1,484,726	1,234,201
Australia	881,820	987,350	982,812	1,060,694	1,043,672
Wheat for Food Use	4,400,367	4,419,111	4,549,127	4,708,290	4,326,330
United States	2,702,902	2,786,293	2,735,782	2,816,800	2,719,568
Canada	1,351,309	1,308,694	1,485,708	1,484,726	1,234,201
Australia	344,095	324,124	327,637	406,764	372,561
Wheat for Feed Use	1,232,288	1,294,188	1,267,202	1,270,034	1,183,284
United States	691,472	630,962	612,027	616,104	512,173
Australia	537,725	663,226	655,175	653,930	671,111

Table 12: Japan's Imports of Cotton, 1981-85

(in metric tons)

	1981	1982	1983	1984	1985
Total	699,708	784,134	666,281	707,973	680,967
United States	258,592	353,274	315,905	372,174	275,611
Australia	55,381	80,767	45,265	60,585	91,426
China	0	8	5,583	23,886	75,240
Pakistan	41,076	35,464	45,690	14,736	75,221
Nicaragua	29,122	26,315	43,320	50,569	37,464
Egypt	30,872	30,558	29,571	30,235	28,172
Mexico	60,938	41,439	28,356	37,673	19,065
Sudan	16,737	13,966	18,035	19,381	17,254
U.S.S.R.	79,554	91,574	42,974	37,981	16,475

Table 13: Japan's Imports of Tobacco, 1981-85

(in metric tons)

	1981	1982	1983	1984	1985
Total	83,320	83,466	80,062	75,175	60,564
United States	51,517	49,810	51,706	45,772	38,748
Turkey	5,440	5,716	5,357	5,262	4,773
Greece	5,467	5,974	4,684	6,922	2,881
Malawi	2,186	2,639	2,929	3,243	2,685

Source for Tables 8-13: Japan, Ministry of Finance

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Demand Stimulus Package Expected In September

Japan's ruling Liberal Democratic Party announced last week that it will complete an economic stimulus package by September 20 that includes Y3 trillion ($19.4 billion at Y155=$1.00) in public works projects. A supplementary budget to cover the projects will be submitted to the extraordinary Diet session convening September 11.

The debate over the ingredients of the program highlights differences between the Ministries of International Trade and Industry and Finance. MITI officials have argued for a sizable increase in public spending to boost reference to the much higher price of Japanese-produced coal. The new MITI head replied that it would be difficult to comply in the short term, but that Tokyo's efforts to restructure the economy in favor of domestic demand should ultimately provide larger markets for Australian goods. Mr. Tamura also urged the Australian government to take a stronger hand in improving the competitiveness of its exporters.

Beef exports were the subject August 12 when Agriculture, Forestry and Fisheries Minister Mutsuki Kato entertained the visiting Australian. Opinions were less harmonious on this subject since Mr. Dawkins claimed that Japan's protectionist policies were the main impediment to increased beef imports. The two agreed, however, to start bilateral talks on beef trade in early 1987.

At his last meeting, Mr. Dawkins met with Finance Ministry officials to discuss the impact of financial liberalization in Japan and Australia. Both governments have been deregulating domestic banking markets in an effort to more completely integrate their financial systems with global money mechanisms. Both are experiencing some disruptions and the two sides exchanged notes on problems and solutions. Canberra plans to send an investment mission to Japan in November and expects a reciprocal visit in 1987.

The surprising agreement on agricultural trade liberalization overshadowed some of the differences on other issues. Whether the two sides really see eye-to-eye will be revealed at the GATT meeting in September.

Jon Choy

MITI To Stimulate Japanese Investment In ASEAN Countries

The Ministry of International Trade and Industry has announced a plan to promote direct investment in member countries of the Association of Southeast Asian Nations. MITI's plan consists of an effort to expand the export-oriented industries of five ASEAN countries: Indonesia, Thailand, Malaysia, the Philippines and Singapore. (Brunei, the sixth member, is not included.) The decision came in response to ASEAN requests made at last July's Japan-ASEAN forum. The ASEAN countries are alarmed at the effect that falling Japanese investment in Asia is having on their foreign exchange reserves, especially now that the prices of many raw materials vital to export earnings are down.

Presently, ASEAN exports primarily mineral resources to Japan and imports primarily manufactured goods (see Table). Since approximately 30 percent of ASEAN exports are sold to Japan, officials are anxious to maintain the strong relationship, and are worried about the recent decline in Japanese imports. Moreover, because of the high substitutability of ASEAN's primary products, officials complain that Southeast Asia is too dependent on Japan, and have called for a more equal trading relationship (see JEI Report No. 27A, July 19, 1985).

MITI has said that, initially, the "Overseas Investment Cooperation Scheme" will be directed at Indonesia, Malaysia and Thailand. MITI is considering assisting Indonesia's nonelectric machinery sector, Malaysia's semiconductor and consumer electronics industries, and Thailand's furniture, food

Japan's Trade With ASEAN Countries*

(in millions of dollars)

	1984	1985
Exports		
Food	$164.5	$124.3
Textiles and Apparel	560.2	485.8
Cotton Fabrics	59.6	65.8
Synthetic Fabrics	229.7	187.6
Chemicals	1,144.6	979.5
Fertilizers	59.9	57.2
Plastics	376.6	289.9
Nonmetallic Mineral Manufactures	257.8	216.4
Metals and Fabricated Metal Products	2,329.1	1,856.5
Iron and Steel Products	1,631.8	1,307.9
Nonferrous Metals	188.1	151.8
Metal Products	509.1	396.9
Machinery and Transport Equipment	8,481.3	6,569.5
Power Generating Equipment	377.1	304.5
Office Machinery	159.4	193.9
Metalworking Equipment	188.3	111.4
Textile Equipment	97.4	68.6
Electric Power Machinery	289.3	212.4
Televisions	103.5	86.8
Radios	173.7	146.0
Electronic Components	745.2	599.8
Motor Vehicles	1363.7	778.1
Vessels	415.9	376.7
Precision Equipment	229.6	235.3
Tape Recorders	354.1	232.0
Other	1,125.3	936.4
Total	14,062.6	11,168.2
Imports		
Food	$1,313.5	$1,280.0
Textile Raw Materials	27.7	31.4
Metal Ores and Scrap	777.7	726.3
Iron Ore	160.6	151.7
Iron and Steel Scrap	9.8	12.2
Nonferrous Metal Scrap	566.9	509.4
Other Raw Materials	2,536.5	2,148.1
Natural Rubber	498.3	396.4
Wood	1,699.6	1,446.7
Mineral Fuels	13,319.0	12,274.6
Petroleum Products	2,335.5	1,926.8
Chemicals	259.2	305.8
Machinery and Transport Equipment	423.5	342.7
Office Machinery	6.5	13.6
Vessels	33.9	0.3
Precision Instruments	33.7	35.2
Other	1164.3	1204.1
Iron and Steel Products	47.1	62.6
Textiles	96.3	85.3
Nonferrous Metals	652.1	602.2
Toys and Games	5.4	7.6
Total	19,821.2	18,313.0

*Thailand, Singapore, Malaysia, Philippines, Indonesia. (Brunei is excluded.)

Source: Japan Tariff Association, The Summary Report: Trade of Japan

processing and plastic molding plants. Tokyo plans to encourage the formation of joint ventures, especially those that would facilitate the transfer of technology and expand ASEAN's export markets.

Special emphasis will be given to improving infrastructure linkages, training more ASEAN engineers, and extending low-interest loans both to ASEAN countries and to Japanese firms that participate in the effort. Japanese officials hope that this plan will encourage the member nations to loosen many of the foreign capital regulations that presently discourage Japanese firms from investing in Southeast Asia.

Although officials see the initiative as a step toward improving close regional relations, a number of other problems remain unresolved. For example, while ASEAN officials had hoped to use the July forum to win tariff reductions on boneless chicken, bananas, coconut oil and other items -- as well as expanded import quotas for pineapples -- Japan only emphasized that it would pursue the efforts that were already under way. Even with regard to the new MITI plan, many ASEAN officials are reserving judgment until they see evidence of Japan's promises. If the plan is put into action, however, it could be an important step toward alleviating one of ASEAN's major complaints: Japan's import concentration on primary products rather than manufactured goods. Another positive result may be a shift of Japanese investment away from already developed sectors toward those likely to open new export markets for member nations.

Eileen Marie Doherty

Washington Bids Tokyo To Open Airport Bidding

Washington is maintaining pressure on Tokyo to open the bidding process for the Kansai International Airport project to international competition. Although Tokyo is coming around to this view, it now claims that the initial construction phase is too far along to entertain new bids. Administration officials are missing no opportunity, however, to prod the Japanese on this issue.

The Ministry of Transportation began to consider building a major new airport facility in western Japan in 1968 after finding that the Osaka airport could not be expanded because of noise and pollution problems. The Kansai International Airport Co., Ltd., the project manager, was created by the national government, the Osaka government (which together own a majority interest) and private industry. The major problem facing the new company was negotiating a compensation package for local fishermen who stood to lose fishing grounds because of the airport's location -- 3.5 miles offshore from the Sennan area of Osaka. Construction was actually scheduled to start this year, but negotiators failed to reach a settlement until March, when it was agreed that the airport company would pay 4,400 fishermen in two prefectures a total of Y40.3 billion ($260 million at Y155=$1.00). The bidding for the first phase of construction will be held this fall and the work will begin immediately.

When the airport opens in 1993, it will have cost an estimated Y1 trillion ($6.5 billion); will accommodate 18.2 million passengers and 657,000

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EXCHANGE RATES AND THE TRADE DEFICIT

Summary

There is growing frustration at the failure of the weakening dollar to stem the expanding U.S. trade deficit. It has now been 18 months since the dollar's peak in late February 1985, and a year since the September 22, 1985 five-nation agreement to lower its value against other currencies. Despite the decline, the trade deficit climbed to a $175 billion annual pace during the first seven months of this year, well above last year's $148.5 billion. Slow growth in the economies of major trading partners, structural changes in the U.S. economy, and the willingness of foreign producers to accept lower profits rather than raise prices all appear to be delaying the impact that the dollar's decline was expected to have on the trade deficit.

The continued expansion of the trade deficit has fueled protectionist pressures in Congress. Japan, which accounts for one-third of the U.S. deficit, has received much of the blame for this country's trade problems. Its huge capital outflows have made it the largest net creditor nation, reflecting its high saving rate. Japan's net assets may reach as high as $400 billion by the end of the decade, while the United States, already the largest debtor nation, is saddled with a foreign debt that could hit $650 billion.

Rising Impatience with the U.S. Trade Deficit

The deterioration in the trade balance has had serious consequences for important sectors of the U.S. economy. The diversion of domestic demand to imported goods has been the major cause of sluggish growth since mid-1984. The economy grew at only a 2.2 percent real annual pace in the first half of 1986, well below the revised Reagan administration forecast of 3.2 percent, and the long-heralded recovery in the second half is proving elusive. Federal Reserve Board chairman Paul Volcker recently warned that the trade deficit is creating a "difficult and dangerous situation," and that the "key to the economic outlook and growth for more than a year is going to be what happens in the trade balance." Mr. Volcker predicted that if this country's exports do not accelerate within a year, the economy could fall into a recession, with serious consequences in a world facing developing-country debt problems.

As the leading trader and investor, the United States has greatly benefited from the liberalization of the world trading system. But the size of the deficit has eroded support for free trade. An April 1986 poll, for example, reported that 45 percent of Americans believe that trade with Japan is bad for this country. Doubts about the benefits of free trade are reflected in the protectionism espoused by Congress, which last fall passed the Jenkins textile-apparel bill, the first blatantly protectionist piece of legislation to pass both houses since the Smoot-Hawley Tariff of 1930. The August 6 vote to override the presidential veto of the bill failed by only eight votes. At the end of June, 248 bills containing import-restrictive provisions were pending.

Even the Reagan administration's commitment to free trade has frayed badly during the past few months under congressional pressure. Since the spring, Washington has asked Japan and three other countries to limit their exports of machine tools; concluded an agreement with Japan that is rapidly raising the prices of semiconductors; signed new, restrictive textile-apparel agreements with Korea, Hong Kong and Taiwan; and upped the ante in its agricultural export subsidy battle with the European Community.

In Japan the escalating trade surplus has created an embarrassment of riches that the government's annual economic report called the country's most urgent economic problem. Tokyo reported a $38.4 billion trade surplus in the first six months of 1986, compared to $23.1 billion in 1985's first half. For the year, it is likely to reach the $84.8 billion mark predicted by the Organization for Economic Cooperation and Development. With its large capital outflows, Japan replaced Great Britain as the world's largest creditor nation in 1985, with $129.8 billion in net assets. A report by the United Nations Conference on Trade and Development (UNCTAD) predicted that if current trends continue, "Japan would become the largest creditor country in history by the turn of the decade, with an unprecedented $400 billion of net external assets and a substantial net investment income."

Causes of the Trade Imbalance

Japan, which accounted for one-third of the 1985 U.S. deficit (nearly one-half if oil is excluded), receives much of the blame for this country's trade problems. On his July visit to Tokyo, Commerce Secretary Malcolm Baldrige warned that protectionist action is likely if Japan's imports fail to increase. Seventy-four of the protectionist trade bills pending in Congress

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would restrict Japanese imports. Many imply a link between Japanese trade barriers and the size of the bilateral deficit.

But the degree of market openness cannot explain the sharp rise in Japan's trade surplus with the United States, given Tokyo's efforts to lower trade barriers during the past several years. The large trade imbalances are instead a result of economic policies pursued in Washington and Tokyo. During the past five years, the two governments have followed divergent fiscal paths. While Japan has been steadily reducing its government budget deficit, the United States has run deficits in the range of $200 billion annually. Although the trade impact of these fiscal policies was unintended, they have had a major effect on both the overall balance in each country and the bilateral balance.

A nation's current account balance is determined by the difference between domestic saving and investment. When domestic investment and the government budget deficit do not absorb private saving, the remainder is invested overseas. That overseas investment must be matched by a corresponding current account surplus. A current account deficit occurs when domestic investment and the government deficit exceed private saving. The shortage of domestic saving is offset by an inflow of capital from abroad that matches the current account deficit. Changes in interest rates and currency values equilibrate the international trade and investment flows.

In 1985 gross private investment in the United States was $661.1 billion and the fiscal deficit (including federal, state and local government) was $136.3 billion. Adding these figures together, the total demand for funds was $797.4 billion. Meanwhile, gross private saving (by individuals and corporations) totaled $687.8 billion. Private sector saving thus fell short of the demand for funds by $109.6 billion. The required inflow of foreign capital approximates (allowing for statistical discrepancy) the U.S. current account deficit of $117.7 billion.

In Japan, in contrast, government budget deficits have been declining since 1980. With private investment at relatively low levels compared to the rapid growth era, the demand for funds has been insufficient to absorb Japan's high level of private saving. As a result, Japan has invested a portion of its saving abroad, which is matched by a current account surplus.

Washington has blamed the "pro-saving, anti-investment" bias in Japan's tax system for the large trade imbalance, while Tokyo identifies the large U.S. budget deficits as the source of the problem. An analysis of the changes in the bilateral trade balances of Japan and the United States with other countries since 1981 (the last year both countries had current account surpluses) indicates that the root of the problem lies primarily in this country. Except for the Organization of Petroleum Exporting Countries, the U.S. trade balance deteriorated across the board (see Table 1). Japan and the European Community each accounted for more than one-fourth of the $108 billion increase in the U.S. trade deficit, while Latin America, the newly industrialized countries of Asia (Taiwan, Korea, Hong Kong and Singapore) and Canada made significant contributions.

Table 1: U.S. Trade Balance, 1981 and 1985

(in billions of dollars, exports f.a.s., imports c.i.f.)

	1981 Trade Balance	1985 Trade Balance	Increase in Deficit	Share of Increase in U.S. Deficit
Japan	$-18.1	$-49.7	$31.7	29.1%
European Community	8.7	-22.5	31.2	28.6
Latin America	1.3	-18.1	19.4	17.8
Newly Industrialized Nations*	-7.0	-25.0	18.0	16.5
Canada	-7.3	-22.2	14.9	13.7
Other Developed Countries	5.3	-3.8	9.1	8.4
Other Developing Countries	2.9	-1.2	4.1	3.8
Communist Bloc	4.2	0.8	3.4	3.2
OPEC**	-29.7	-6.8	-22.9	-21.0
Total	-39.6	-148.5	108.9	100.0

*Includes Taiwan, Korea, Hong Kong and Singapore.
**Excludes Venezuela and Ecuador.

Source: Department of Commerce

Table 2: Japan's Trade Balance, 1981 and 1985

(in billions of dollars, exports f.o.b., imports c.i.f.)

	1981 Trade Balance	1985 Trade Balance	Increase in Surplus	Share of Increase in Japan's Surplus
United States	$13.3	$39.5	$26.2	70.1%
OPEC*	-32.1	-23.2	8.8	23.6
China	-0.2	6.0	6.2	16.6
European Community	10.3	11.1	0.8	2.1
Newly Industrialized Nations**	12.3	12.7	0.3	0.9
Other Developed Countries	-1.3	-1.3	0.1	0.2
Communist Bloc***	2.0	1.7	-0.3	-0.7
Latin America	3.8	2.2	-1.6	-4.3
Other Developing Countries	0.5	-2.6	-3.1	-8.4
Total	8.7	46.1	37.4	100.0

*Excludes Venezuela and Ecuador.
**Includes Taiwan, Korea, Hong Kong and Singapore.
***Excludes China.

Source: Ministry of Finance

If the cause of Japan's widening trade surplus lay in Tokyo, one would expect the increase to be spread evenly among its trading partners. Instead, the United States alone accounts for 70 percent of the increase and OPEC accounts for 24 percent (see Table 2). Had Japan's balance with OPEC and this country remained at 1981 levels, its 1985 trade surplus would have been only $11.1 billion. Thus the underlying cause of the imbalance lies largely in the United States.

The U.S. Trade Deficit

Despite the decline in the dollar, many economists remain pessimistic about the prospects for a substantial improvement in the U.S. trade balance. U.S. Trade Representative Clayton Yeutter said last week that the trade deficit will approach $200 billion this year. In the absence of additional policies in Western Europe and Japan to stimulate domestic demand, reduction of the deficit will require a further decline in the dollar. Although the administration expects the trade deficit to begin shrinking later this year, it is unlikely that it will improve quickly. The OECD expects only an $8 billion decline in the U.S. trade deficit in 1987.

On a trade-weighted basis, the dollar has fallen 11.4 percent against the currencies of this country's 20 largest trading partners since February 1985, with most of the decline coming after the September 1985 five-nation agreement to lower the dollar's value (see Table 3). The dollar's decline has been moderated by its failure to depreciate relative to the currencies of many major developing countries. In contrast to the sharp decline against the yen and the German mark, the dollar has remained constant against the Canadian currency and appreciated against the Korean won since February 1985. The value of the won is based on a basket of currencies heavily weighted to the dollar and recent administration efforts to discuss exchange rates with Seoul have been rebuffed.

Moreover, some observers believe that the realignment of exchange rates cannot adequately lower the U.S. trade deficit for several reasons. One is that U.S. exports are limited by modest growth in many of this country's important trading partners. The administration has strongly urged Japan and West Germany, which both recorded negative growth in the first three months of 1986, to adopt more stimulative policies. In addition, the debt problems of developing countries limit U.S. exports.

On the import side, it is also clear that foreign producers will not give up market share in this country without a struggle. After several years of substantial earnings, they are willing to cut costs and sacrifice profits rather than lose market share by raising prices by the full amount of the currency changes. Japanese exporters, for example, passed on only 53.8 percent of the yen's rise in the form of price increases in the eight months from September 1985 (see Table 4). The pass-through ratios for basic industrial intermediates such as steel and nonferrous metals are especially low. In 1978, in contrast, rapid growth and high inflation in the United States and other industrialized countries enabled Japanese firms to raise prices by the full amount of the yen's appreciation without sacrificing export volume.

Table 3: Changes in Dollar Relative to Currencies of Major Trading Partners

Currency of*	Share of U.S. Trade in 1985**	Percentage Change from End of February 1985	
		September 1985	September 2, 1986
Canada	20.3%	-0.9%	0.1%
Japan	16.5	-8.7	-40.7
Mexico	5.7	19.3	57.1
West Germany	5.3	-14.5	-39.1
United Kingdom	4.7	-20.1	-27.0
Taiwan	3.9	0.0	-5.7
Korea	2.9	5.8	4.8
France	2.8	-15.0	-34.8
Italy	2.6	-8.1	-32.5
Hong Kong	2.0	0.2	-0.0
Netherlands	2.0	-15.2	-39.3
Brazil	2.0	-0.4	-6.5
Venezuela	1.8	9.0	50.5
Australia	1.5	3.6	17.2
Belgium	1.5	-14.3	-37.4
China	1.4	4.5	31.0
Singapore	1.4	-1.5	-5.1
Saudi Arabia	1.1	2.0	4.9
Sweden	1.1	-10.6	-26.9
Switzerland	1.0	-17.7	-42.4
Trade-Weighted Average		-4.0	-11.4

*Since August 1986 inflation rates are not available for most countries, all percentage changes are calculated using nominal exchange rates. Admittedly, it is real, not nominal rates, that affect trade flows. Among industrial countries, though, changes in nominal exchange rates have closely paralleled changes in real rates. For Mexico and Brazil, two countries with rapidly rising price levels, September 1985 nominal exchange rates were adjusted based on reported inflation rates and the September 1986 rate was adjusted based on projected inflation rates. Excluding Mexico and Brazil, the dollar declined 5.9 percent through September 1985 and 16.8 percent through September 2, 1986.

**The top 20 trading partners listed above accounted for 81.5 percent of U.S. trade (exports plus imports) in 1985.

Source: International Monetary Fund and Journal of Commerce.

Table 4: Share of Yen's Rise Reflected In Export Prices

(September 1985 to April 1986)

Industry	Percent
Steel	-1.0%
Nonferrous Metals	8.6
Chemicals	26.8
Textiles	40.0
Precision Machinery	60.3
Electric Machinery	66.2
Automobiles	71.9
Nonelectric Machinery	72.4

Source: Bank of Tokyo, Tokyo Financial Review, July 1986.

Another line of argument holds that structural changes in the economy lessen the effect of currency changes on the trade deficit. Outsourcing by U.S. manufacturers, for example, has made many firms dependent on Japanese imports. According to a study by the Japan External Trade Organization, about 30 percent of Japan's shipments to this country in 1984 were closely linked to U.S. manufacturing activities. Moreover, many of the products now imported by this country, such as compact discs and video cassette recorders, are not made here.

Even if currency changes have the hoped-for effect on trade, the possibility remains that the dollar will reverse course and return to its high levels of the past few years. According to Martin Feldstein, former chairman of the Council of Economic Advisers, "It [is] not currency intervention or coordinated jawboning that have depressed the dollar since September but the basic fundamentals of the decline in international interest differentials and the reduction in projected U.S. budget deficits." Should the budget cuts not materialize and interest rate differentials increase, the dollar is likely to appreciate again.

Since economists estimate that it takes 18 to 24 months for a currency devaluation to improve the trade balance, it is still too early to conclude that exchange rate changes are ineffective. Moreover, since the dollar devaluation did not occur all at once but has been stretched out over 18 months, it is natural that the improvement will take longer than expected. But there are a few signs that it is beginning. In the April-June quarter, inflation-adjusted U.S. exports increased for the third consecutive quarter and were nearly 3 percent above year-earlier levels.

Japan's Trade Surplus

With a nearly 20 percent rise in exports and a small decline in imports, Japan's trade surplus hit a record $38.4 billion in the first six months of 1986. Many observers, though, believe Japan's trade surplus will begin falling by the end of the year, given the sharp appreciation of the yen. The yen has risen 68.3 percent on a trade-weighted basis against the currencies of Japan's top 20 trading partners during the past 18 months (see Table 5). While this revaluation has begun to affect trade flows, changes in the volume of trade thus far have been overwhelmed by the shift in the terms of trade. This year's white paper on international trade estimates the J-curve effect accounted for 70 percent of the rise in value of Japanese exports in FY 1985.

Table 5: Changes in Yen Relative to Currencies of Major Trading Partners

Currency of*	Share of Japan's Trade in 1985**	Percentage Change from End of February 1985 September 1985	 September 2, 1986
United States	29.8%	9.5%	68.6%
China	6.2	14.5	120.9
Saudi Arabia	4.6	11.7	76.8
Australia	4.2	13.4	97.7
Indonesia	4.0	12.5	74.9
Korea	3.7	15.9	76.7
United Arab Emirates	3.3	9.5	68.7
West Germany	3.2	-6.4	2.7
Canada	3.0	8.5	68.8
Taiwan	2.8	9.5	59.0
Hong Kong	2.4	9.7	68.6
United Kingdom	2.1	-12.5	23.2
Malaysia	2.1	5.3	69.8
Singapore	1.8	7.9	60.1
Soviet Union	1.4	0.7	30.0
Iran	1.3	2.4	35.9
Oman	1.2	9.5	87.7
France	1.1	-6.9	9.9
Thailand	1.0	5.6	56.8
Switzerland	1.0	-9.8	-2.8
Trade-Weighted Average		8.5	68.3

*Since August 1986 inflation rates are not available for most countries, all percentage changes are calculated using nominal exchange rates. Admittedly, it is real, not nominal rates, that affect trade flows. Among industrial countries, though, changes in nominal exchange rates have closely paralleled changes in real rates.

**The top 20 trading partners listed above accounted for 80.3 percent of Japanese trade (exports plus imports) in 1985.

Source: International Monetary Fund and Journal of Commerce.

The strong yen, combined with slower growth in major trading partners, cut Japan's export volume 0.5 percent in the first six months of 1986 compared to the same period a year earlier. There have been sharp drops in some products (see Table 6), as Japanese goods became less competitive in overseas markets. Korea, for example, instructed domestic producers earlier this year to find European and U.S. suppliers for 30 industrial, electronic and chemical products currently imported from Japan. In addition, currency changes have encouraged Japanese firms to manufacture overseas, also reducing exports. According to a report by the U.S. Labor Department, the average Japanese worker now makes the equivalent of $9.22 per hour, more than six times higher than the rate in Taiwan and Korea and up to 71 percent of the $12.97 earned by U.S. workers. In 1984 Japanese workers earned about four times the hourly wage rate in Taiwan and Korea and only half the American rate.

Table 6: Japan's Export Volume, January-June 1986

(percentage change from first half of 1985)

Industry	Percent
Color Televisions	-51.6%
Cement	-34.0
Steel Bars	-33.0
Toys	-24.0
Binoculars	-23.0
Polyester Fiber	-20.5
Tires	-5.3
Trucks	-4.6
Forklifts	-3.6
Rolled Steel Products	-3.5
Personal Computers	-1.6
Machine Tools	-1.4
Automobiles	11.6
Cotton Fiber	4.8
Video Cassette Recorders	14.2
Cameras	14.8
Semiconductors	16.0
Acrylic Fibers	16.2
Watches	25.8
Photocopiers	45.4

Source: The Economist, August 9, 1986.

The impact of exchange rate changes on Japanese imports is limited by the low ratio of manufactured goods to total imports. According to Sumitomo Bank, Ltd., demand for raw material imports is much less sensitive to price changes (with a price elasticity of 0.24) than is demand for manufactured goods (with a price elasticity of 0.81). In 1985 manufactured goods accounted for only 31 percent of Japanese imports, compared to 60 to 75 percent for the United States, West Germany, Great Britain and France. Despite this distribution, Japan's imports increased 10.2 percent in volume terms in the first six months of 1986 compared to year-earlier levels. The rise was led by a 23.7 percent jump in manufactured imports, although most of it was due to a temporary surge in gold imports for use in minting commemorative coins. According to an econometric study by Sumitomo Bank, assuming an exchange rate of Y180=$1.00, manufactured imports will increase $8.3 billion in FY 1986.

In summary, Japan's trade surplus will recede gradually, as the decline in the volume of exports accelerates and the volume of manufactured imports increases. OECD officials estimate that Japan's surplus will fall by $4 billion in 1987. But given its high saving rate, it is likely that Japan's trade surplus at the end of the decade will remain substantial.

Conclusion

It is unlikely that huge U.S. trade deficits offset by equally large capital inflows can continue indefinitely. Once foreign investors refuse to continue making large net investments in this country, the trade deficit will no longer be sustainable. Martin Feldstein believes that the United States will run major trade surpluses in the 1990s. A trade surplus will be necessary to service this country's foreign debt, which the Institute for International Economics estimates will reach $650 billion by the end of the decade. Interest payments on a debt of that size will absorb at least 2 percent annually of U.S. gross national product.

Since the U.S. deficit accounted for most of the rise in Japan's trade surplus, its reduction should encourage a contraction in Japan's surplus. With the foreign sector becoming a drag on the economy, Japan will depend on domestic demand, as it did during the 1970s. During that decade, the external sector accounted for more than half of the country's growth only once; in four years it was a negative factor (see Table 7). The external sector is likely to slow growth in 1986, making structural reforms, such as those proposed by the Maekawa Commission, important to boost growth.

Table 7: Components of Japan's Economic Growth

(real growth in percent)

	Total Rate	Domestic Component	External Component	Current Account Surplus*
FY 1970	8.3%	8.9%	-0.7%	$2.3
FY 1971	5.3	4.0	1.3	6.3
FY 1972	9.7	10.6	-0.8	6.2
FY 1973	5.3	7.5	-2.2	-3.9
FY 1974	-0.2	-2.8	2.6	-2.3
FY 1975	3.6	2.0	1.6	0.1
FY 1976	5.1	3.6	1.5	4.7
FY 1977	5.3	4.2	1.0	14.0
FY 1978	5.1	6.9	-1.8	11.9
FY 1979	5.3	4.8	0.5	-13.9
FY 1980	4.6	1.4	3.3	-7.0
FY 1981	3.6	1.9	1.7	5.9
FY 1982	3.4	3.0	0.4	9.1
FY 1983	3.9	2.2	1.8	24.2
FY 1984	5.3	4.0	1.3	37.0
FY 1985	4.2	3.5	0.7	55.0

*In billions of dollars.

Source: Economic Planning Agency

Meanwhile, Japan will continue to run a large trade surplus, estimated at about 4.1 percent of GNP this year, and will supply capital to the rest of the world. Tokyo's role is certainly not unique in economic history; at the height of the British Empire, Britain's surplus reached 3.8 percent of GNP, while the U.S. surplus in the years following World War II rose as high as 4 percent. Japanese capital exports during the past few years have benefited the United States by preventing a rise in interest rates and supporting the economic expansion.

Some observers have urged Japan to curb its high saving rate to bring its international accounts back into balance. But it is unwise to encourage a rich country to consume more when developing nations are short of capital. World Bank president Barber Conable has called Japan's trade surplus "a world asset" that should be mobilized for development aid.

At present the bulk of Japan's surplus is invested in industrialized countries, particularly the United States. Several weeks ago, Masayoshi Ito, chairman of the Liberal Democratic Party's Policy Affairs Research Council, assailed Japanese companies for pouring earnings into U.S. securities instead of investing in countries with unemployment problems and high foreign debt burdens. Financial innovations will be required to encourage such a shift, however. During his recent visit to Tokyo, Mr. Conable reported that the World Bank has begun studying a variety of approaches intended to recycle Japan's surplus to the developing countries.

For further information, contact Randall S. Jones.

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Japan's Economy Sends Mixed Signals

Japanese officials appear to be backing away from the government's target of 4 percent real growth in fiscal 1986 (April 1, 1986-March 31, 1987), which was based on an exchange rate of Y204=$1.00. Currently, the yen is trading around Y155=$1.00. In the long run, the increased purchasing power resulting from the strong yen and lower oil prices will benefit Japan's economy, but during FY 1986, the negative effect of lower export earnings will be dominant, slowing growth.

Business leaders fear that Japan may be headed for its first recession in more than three years. Gross national product contracted at a 2.1 percent annual rate during the first three months of 1986, the first negative quarter since 1975. Last month's report by the Economic Planning Agency added to the pessimism, calling business conditions slack while avoiding the term "economic expansion" in referring to the economy.

The strong yen is reflected in the 0.9 percent drop in export volume in July, the fifth consecutive monthly decline. Based on the April-June quarter, the Waco Research Institute of Economics estimated that the pretax profits of Japan's 425 largest corporations (excluding banks, insurance companies, utilities and oil companies) will decline 29.4 percent in FY 1986. Smaller profits and slower growth have, in turn, made manufacturers bearish in their investment plans. Finance Minister Kiichi Miyazawa expressed concern last week that these trends will worsen employment conditions. Unemployment rose to 2.9 percent in July, matching the postwar record set in April. The jobless rate for men topped 3 percent for the first time, while employment in the manufacturing sector fell from year-earlier levels for the fifth consecutive month.

There are some bright spots in the economy, however. Consumer spending appears steady and housing starts rose 13.5 percent in July over the year-earlier period. Housing construction should remain strong during the rest of the year because of lower interest rates. As long as consumer spending and housing (which together account for 60 percent of GNP) hold firm, the economy will not fall into a recession.

According to EPA officials, real economic growth in fiscal 1986 will be about 2.8 percent, which would be the lowest rate since FY 1975. It is certain to fail to satisfy U.S. officials, who are hoping for more rapid Japanese growth to boost this country's exports. U.S. officials continue to pressure Tokyo for stimulative measures. At an unannounced September 6 meeting between Mr. Miyazawa and Treasury Secretary James Baker in San Francisco, Mr. Baker expressed doubt over Tokyo's commitment to meet the 4 percent target and urged Japan to act quickly to raise domestic demand.

The Japanese government has announced that a package of stimulative measures will be introduced September 19. The program is likely to include increased public works spending and promotion of housing construction; flexible monetary policy; deregulation of private business; measures to help small businesses hurt by the strong yen; and measures to pass on the windfall profits from the yen appreciation to consumers. Mr. Miyazawa said that no figure has been set for public works spending, which will be a major part of the supplementary budget to be submitted to the Diet this fall. Prime Minister Yasuhiro Nakasone said September 9 that the package will contain spending of Y3 trillion ($19.4 billion at Y155=$1.00).

Randall S. Jones

Ministries Announce Initial Budget Requests

Japan's initial round of budget negotiations was completed at the end of August when the twelve ministries and six independent agencies submitted their initial budget requests for fiscal 1987. The major features of the general account budget conformed to the cabinet's guidelines (see JEI Report No. 28B, August 1, 1986), although discretionary spending will rise only 0.5 percentage point as opposed to the suggested 1 percentage point. Prime Minister Yasuhiro Nakasone has maintained fiscal austerity despite his appointment of the more expansion-minded Kiichi Miyazawa as finance minister.

The following table reveals the initial results of the budget negotiations. The largest gain is projected for debt service costs -- nearly a 25 percent increase. Almost one of every four yen of general account outlays will be earmarked for interest payments on the national debt in FY 1987, in contrast to one of every five this fiscal year. On a more encouraging note, aggregate official development assistance is scheduled to expand 7.5 percent as Tokyo continues to extend a bigger helping hand to developing nations.

Initial FY 1987 Budget Requests by Ministry

(in billions of yen)

	FY 1986	FY 1987	Percent Change
Justice	Y390.2	Y401.7	2.9%
Foreign Affairs	419.3	440.5	5.0
Finance	1,278.4	1,302.7	1.9
Education	4,572.2	4,578.8	0.1
Health and Welfare	9,772.1	10,190.9	4.3
Agriculture, Forestry and Fisheries	2,787.6	2,735.1	-1.9
International Trade and Industry	782.2	742.5	-5.1
Transportation	1,015.2	665.5	-34.4
Posts and Telecommunications	24.2	24.6	1.9
Labor	488.9	488.2	-0.1
Construction	3,774.0	3,693.0	-2.1
Home Affairs	106.4	76.4	-28.2
Imperial Palace	3.0	2.9	-1.4
Diet	83.7	83.7	-0.1
Judiciary	229.8	233.3	1.5
Audit Bureau	10.5	10.8	2.1
Cabinet	11.6	11.8	1.1
Prime Minister's Office	6,835.0	7,063.7	3.3
Total Discretionary Spending	32,584.2	32,746.0	0.5
of which Defense:	3,343.5	3,554.1	6.3
National Debt Payments	11,319.5	14,138.7	24.9
Transfers To Local Governments	10,185.0	10,815.6	6.2
Total General Account	54,088.6	57,700.3	6.7

Source: Ministry of Finance

The Ministry of Foreign Affairs is asking for Y316.9 billion ($2 billion at Y155=$1.00) in ODA, a 7.4 percent increase. Together with ODA requests from 14 other ministries totaling Y351.7 billion ($2.3 billion), Japan hopes to spend Y668.6 billion ($4.3 billion) from its general account budget on foreign aid. In addition, MOFA wants to set aside Y600-Y700 billion ($3.9-$4.5 billion) in yen loans for aid projects from the Fiscal Investment and Loan Program, Tokyo's second, self-financing budget. MOFA will seek to improve the quality of aid by selecting better development projects; shrinking the share of each project borne by the recipient country; restructuring existing projects that have experienced problems; and hiring consultants on foreign aid to evaluate its programs. MOFA was disappointed that FY 1985's ODA disbursements fell short of its goals and is seeking remedies to procedural bottlenecks (see JEI Report No. 24B, June 27, 1986). The stronger yen should also help MOFA meet its pledge to spend $40 billion in aid over the FY 1986-FY 1992 period.

At the Ministry of International Trade and Industry, officials have highlighted the agency's efforts to restructure the economy. The ministry wants to pump Y138.5 billion ($893.6 million) from its general account budget and Y29 billion ($187.1 million) from the FILP's industrial investment special account into programs to help small businesses deal with the yen's appreciation and restructure their operations to meet domestic demand. MITI wants another Y12 billion ($77.4 million) from the same special account to establish an "economic structure adjustment fund" aimed at helping local economies and small industries. Overseas direct investment promotion is to receive Y1.4 billion ($9 million). Domestic demand stimulation and regional economic development projects will consume Y100 million ($645,000), mostly for research and development centers, industrial parks and exhibition centers.

MITI's contribution to ODA will total Y21.6 billion ($139.4 million) and will be devoted to industrialization projects. As for science and technology promotion, the ministry is seeking Y50 million ($323,000) for its "human frontier" program, which seeks to develop bionics through large, joint international research projects. In addition, it will continue to fund numerous industrial technology programs, including development of the V2500 jet engine, the YXX passenger aircraft and the fifth-generation computer project.

There are signs of the "greying" of Japan, as the Health and Welfare Ministry's budget topped Y10 trillion ($64.5 billion) for the first time. Under its "policy for a long-life society," MHW will improve and double the number of day-care centers for senior citizens; strengthen research into the prevention and treatment of senile dementia and increase funding for biotechnology research. A record Y4 trillion ($25.8 billion) was requested for pension fund and medical care operations. MHW feels that more needs to be done, however. To supplement the estimated 1,100 welfare pension programs in Japan (representing 7.1 million participants and Y11.3 trillion ($2.9 billion) in assets as of March 31, 1986), MHW wants to establish an organization to help care for the elderly at an initial cost of Y3 billion ($19.4 million) -- with Y1 billion ($6.5 million) each coming from the general account, public pensions funds and private industry.

The Japan Defense Agency continued to hold its favored status with Mr. Nakasone's budget planners, garnering a 6.3 percent increase (slightly below the cabinet's 6.4 percent guideline). Air defense hardware forms the core of

JDA's Y1.7 trillion ($11 billion) weapons purchase plans; 16 F-15 interceptors, 12 P-3C anti-submarine planes and the Patriot surface-to-air missile system are listed, along with three destroyers. In addition, Y49 million ($316,000) will be spent on communications facilities to link air and sea forces with land bases via commercial satellites and Y6 million ($39,000) will be spent to study the construction of a very-long-range radar base in Japan.

It is important to remember that lengthy negotiations between Finance and other ministries have yet to take place before the final budget is compiled in December. Nevertheless, it is clear that while fiscal austerity rules overall expenditures, particular programs continue to receive special treatment.

Jon Choy

Japanese Defense Head Meets Administration Officials; Tokyo Approves SDI

Japan Defense Agency director general Yuko Kurihara met with top officials of the Reagan administration in Washington last week, assuring them that Japan would make every effort to meet its defense obligations. U.S. officials, in return, urged an increase in Tokyo's defense spending to offset increasing pressures in Washington that could affect both trade and defense relations.

Mr. Kurihara's visit was his first to Washington after resuming the defense post in the Nakasone government, which has been assured of another year in existence (see article in this issue). Japanese officials briefing the press said that Secretary of Defense Caspar Weinberger had told Mr. Kurihara that Congress is taking an increasingly isolationist posture, necessitating a larger Japanese defense role. Mr. Kurihara responded that Japan is in the process of fulfilling its five-year defense plan through an anticipated 6 percent spending hike for fiscal 1987.

Discussions also touched on less dramatic but equally important issues for the two allies, including Tokyo's decision to press ahead on construction of a controversial landing strip on Miyake Island for U.S. night landing exercises and U.S. requests for expanded payments for support of American forces in Japan.

On Mr. Kurihara's return to Japan, the Nakasone government formally announced its decision to allow participation in the Strategic Defense Initiative research program, although there are lingering concerns over repatriation of technology generated under SDI contracts by Japanese firms. Tokyo will now begin the long process of finalizing the terms of Japanese participation in the program.

In the meantime, officials have completed arrangements for transfers of dual-use technologies from Japan to the United States under notes exchanged in November 1983. The technologies, which involve missile image-seeking technology and ship design and production techniques, will be the first completed under the notes in what Washington hopes will be a significant flow in the future. Tokyo and Washington agreed to the transactions in principle in December 1985.

Michael W. Chinworth

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JEI

REPORT

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September 19, 1986

JAPAN AND SUB-SAHARAN AFRICA: ECONOMIC AND POLITICAL RELATIONS

Summary

Despite the vast mineral resources of the sub-Saharan region, its great distance from Japan, extreme poverty and economic instability effectively discourage Japanese entrepreneurs from increasing trade and investment activities there. Although economic relations expanded after the oil crises of the 1970s, trade and capital investment have been declining in recent years. While South Africa is a major exception and is one of Japan's largest suppliers of mineral resources, political considerations may prompt the Japanese government to place additional limitations on activities in that country. Japanese officials expect that Africa will continue to be of secondary economic importance until progress is made in rectifying the serious structural problems facing the region.

In light of these constraints, Japan has increased its foreign aid efforts in the region, concentrating on agricultural development. Aid -- in the form of grants, technical assistance and to a lesser extent loans -- is the primary link between Japan and sub-Saharan Africa, and some observers predict that it will become Tokyo's number-two aid priority (after Asia). While Japan has few overt political goals in the subcontinent -- other than its attempt to balance economic interests in South Africa with its political opposition to apartheid -- it recognizes the need to participate in human and institutional development projects.

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Introduction

Historically Japan has had very little contact with sub-Saharan Africa. Because Japan was never a colonial power in Africa, relations were limited before African independence. Even then, Japan did not have the same African expertise or background as the former colonial powers; moreover, many of the most profitable enterprises were already controlled by these nations.

As a result, the Japanese government paid little attention to African affairs prior to the 1970s, and its trading interests were minor compared to most other major areas of the world. Relations consisted chiefly of limited -- and strongly laissez-faire -- private activities. However, the oil shock of 1973 heightened Tokyo's interest in the region as an alternate source of energy supplies. As part of the new "resource diplomacy," the government strengthened its African expertise in the Foreign Ministry and addressed itself to policies designed to coordinate government and private-sector interests. It is significant that the first two visits by Japanese foreign ministers to Africa took place in 1974 and 1979, each one year after a major oil crisis. This turn toward Africa was reflected in increasing trade and investment figures in the late 1970s and early 1980s. But as the stability and well-being of the subcontinent continued to deteriorate, the Japanese turned to other areas of the world for raw materials and capital investments.

These trends reflect the government's awareness that, despite the region's enormous economic potential, structural problems in sub-Saharan Africa have reached a dangerous point. The African continent contains 30 percent of the non-communist world's mineral resources, except for oil. Yet skyrocketing population growth combined with lagging agricultural development have given rise to rapid urbanization without industrialization -- hence, huge unemployment levels. The problems caused by the population explosion have been exacerbated by an average 1 percent annual decrease in per-capita food production since 1970. Of those commodities under cultivation, many are raised for export rather than consumption, including tobacco, cotton, soybeans, cocoa, coffee and peanuts. Moreover, in recent years natural disasters have become commonplace. Between 1980 and 1985, a series of droughts ravaged more than half of the African countries, causing serious food shortages that led to an increasing death toll from hunger. The gravity of these crises led Japan to place increased emphasis on humanitarian aid to the subcontinent.

Trade and Direct Investment

Japan's total trade with Africa was $8.2 billion in 1985, with imports of $3.5 billion and exports of $4.7 billion. Trade with the region grew at a steady pace following the 1973 oil crisis, but peaked in 1981 when imports reached $4.8 billion and exports $10 billion -- a total of $14.8 billion. Since 1981 the value of Japan/Africa trade has been steadily declining. Japan's largest trading partner in the region is South Africa, which imported $1 billion worth of Japanese goods and services in 1985 and exported $1.8 billion. Other major importers include Liberia, Nigeria, Kenya, the Canary Islands, Cameroon, the Ivory Coast and Tanzania. Japan's primary suppliers in the region are Zambia, Liberia, Ghana, Zaire and Zimbabwe (see Tables 1 and 2).

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Table 1: Japan's Exports to Selected African Countries, 1971-72 and 1984-85

(in millions of dollars)

	1971	1972	1984	1985
South Africa	$412.5	$364.1	$1,839.9	$1,019.9
Nigeria	96.0	126.0	445.5	342.0
Kenya	48.6	46.6	150.4	140.1
Liberia	998.8	1022.0	854.9	647.1
Ivory Coast	14.3	16.6	40.8	70.8
Ghana	31.4	13.3	30.2	41.6
Canary Islands	24.7	37.0	84.8	106.8
Cameroon	5.0	6.7	57.6	69.7
Zaire	64.1	48.2	40.8	43.5
Tanzania	17.5	21.2	78.3	75.7
Zimbabwe	0.005	0.02	35.5	24.7
Zambia	33.8	51.8	34.6	60.1
Sudan	13.8	18.1	53.0	39.9
Ethiopia	26.3	27.5	49.6	56.8

Source: Japan Tariff Association, The Summary Report: Trade of Japan

Table 2: Japan's Imports from Selected African Countries, 1971-72 and 1984-85

(in millions of dollars)

	1971	1972	1984	1985
South Africa	$319.1	$398.9	$1,610.6	$1,843.9
Nigeria	27.1	80.0	7.0	5.8
Kenya	8.4	9.9	17.0	11.0
Liberia	74.3	72.1	98.7	58.0
Ivory Coast	9.4	12.1	65.0	33.4
Ghana	40.5	46.8	71.0	67.5
Canary Islands	9.3	8.9	0.3	0.1
Cameroon	9.9	9.4	22.1	16.9
Zaire	26.9	27.1	84.5	52.4
Tanzania	9.1	11.5	17.1	16.7
Zimbabwe	0.02	0.0	71.2	55.9
Zambia	149.1	165.4	202.4	222.6
Sudan	27.2	29.0	48.7	48.9
Ethiopia	10.2	14.2	33.1	41.4

Source: Japan Tariff Association, The Summary Report: Trade of Japan

Industrial products, especially machinery, made up a full 89 percent of Japan's exports to the region in 1984. Approximately two-thirds of Japan's imports consisted of raw materials, foodstuffs and mineral fuels, with manufactured goods accounting for the remainder. The region sells Japan chromium, copper, manganese, cobalt and uranium ore, as well as cocoa, coffee, cotton, fish products and sugar (see Tables 3 and 4).

One problem facing the relationship is the trade imbalance. Although the gap has been narrowing in recent years, it has been more a function of Japan's turning to other export markets rather than buying more goods from the region. And while the problem was aggravating enough for Kenyan President Daniel Arap Moi to threaten import restrictions against Japanese products at one point, Japanese officials do not expect to increase deliveries to the subcontinent. In light of the region's economic insecurity, geographic distance and development problems, there are few items produced in Africa that Japan cannot buy more inexpensively and efficiently elsewhere. One Japanese official said simply, "Africa doesn't have much to sell."

Japanese investment in sub-Saharan Africa is limited and has been declining annually from a peak of $573 million in 1981 to a 1985 level of $172 million. The cumulative total of foreign direct investment in the continent amounted to $3.4 billion in 1985 (see Table 5). This accounts for only 4 percent of total Japanese investment, making Africa's share the second-lowest by geographic region (ahead of the Middle East). Moreover, there was a 47.2 percent decline between FY 1984 and FY 1985. Ninety percent of these funds are concentrated in four countries -- Liberia, Zaire, Nigeria and Zambia. No other country in the region has more than $100 million in direct investments. However, much of the capital invested in Liberia, which accounts for 82.7 percent of total investments in Africa, consists of Japanese ships registered in the country. Such "paper investment" does little to spur development in the region.

According to one Japanese official, investment levels in Africa are low for one major reason: businesses can engage in more efficient, profitable ventures in other areas of the world. For this reason, Southeast Asia and Latin America are more likely to host Japanese investments in natural resources. Economic security is also an issue; a U.S. official noted that although the threat of nationalization has diminished since the 1970s, "business has a long memory."

There is also a fundamental conflict about the types of investments to be undertaken. Many African countries are not eager to participate in projects that involve only large-scale extraction of raw materials. Not only are they anxious to conserve energy and mineral supplies but they also prefer to engage in ventures that facilitate industrialization. Industrial projects, however, rarely interest Japanese investors, who concentrate instead on projects in the mining and energy sectors, textiles and fisheries, including:

- Joint-venture uranium mines in Nigeria and Mali, and iron ore in Liberia. (Disappointing returns prompted a recent disinvestment in Zaire's copper.)

- Joint ventures in the fishing industries of the Gambia, Ghana, the Ivory Coast, Mauritania, Nigeria and Senegal.

- A cotton spinning and weaving company in Tanzania.
- A refrigeration and air conditioning factory in Ghana.
- Oil production in Gabon, and
- Several transport and infrastructure projects, especially in resource-rich countries.

Observers predict that investment activities will continue to decline as long as mineral resources are available elsewhere. When asked if there were any potential investment opportunities on the subcontinent, one Japanese official suggested Zambian copper, but quickly pointed to alternative copper markets in Australia and Canada.

Political Relations

Japan has a small political presence in Africa, with embassies in fewer than half of the countries on the continent. Many of these devote their energies to facilitating private business activities in the region rather than pursuing political goals. Japan has no ideological or political mission in Africa, so these countries take a political back seat.

Nonetheless, the sheer number of sub-Saharan countries gives them a certain amount of political power -- for example, in the United Nations -- and Japanese officials recognize the importance of maintaining cordial if not close relations with the region. In the 1970s efforts to cultivate African goodwill were manifested in low-key support for certain political issues, including African liberation movements; quick recognition of post-revolutionary regimes in Guinea-Bissau, Mozambique and Angola; and support for certain third world positions in the United Nations. This decade has seen more emphasis on development assistance as a means of bolstering relations. To a lesser extent, former Foreign Minister Shintaro Abe emphasized the role of "security aid" to ensure continued African presence in the Western camp.

A major consideration facing Japanese officials is how to balance Japan's economic interests in South Africa with a political need to distance itself from Pretoria. Japan's limited goals in black-ruled Africa, its lack of historic or ethnic ties with either South African whites or blacks, and its sparse economic ties in the region mean that there is less pressure to take action against apartheid than in the United States and the former European colonial nations. Nonetheless, Tokyo does not want to jeopardize its cordial relations with black-ruled Africa -- or more importantly, antagonize Western opinion -- by embracing South Africa. For these reasons, Japan views limited sanctions as a political necessity.

Japanese Aid to Africa

If trade and investment have been declining in recent years, economic aid has been steadily expanding. The total volume of bilateral Official Development Assistance to African countries (excluding Egypt, Libya, Morocco, Algeria, Tunisia and South Africa) increased 130 percent between 1973 and 1984.

Table 3: Japan's Exports to Africa by Commodity, 1981-84*

(in millions of dollars)

Exports	1981	1982	1983	1984
Total	$10,038.5	$6,930.4	$6,006.1	$6,358.1
Food	227.3	200.0	166.8	78.0
Industrial Raw Materials and Fuels	35.5	31.7	19.6	19.0
Light Industrial Products	967.5	657.9	638.4	608.6
Heavy Industrial Products	8,782.8	6,031.7	5,170.3	5,644.2
Metals	1,163.9	968.9	623.1	638.1
Steel	855.0	683.6	394.7	412.2
Machinery	7,441.0	4,928.6	4,427.1	4,882.0
Motor Vehicles	2,154.6	1,245.7	1,041.1	1,253.2
Vessels	1,793.7	1,066.7	708.0	951.8

*Figures include North African countries, which in 1984 accounted for 35.3 percent of total Japanese exports to Africa.

Source: JETRO, White Paper on International Trade

Table 4: Japan's Imports from Africa by Commodity, 1981-1984*

(in millions of dollars)

	1981	1982	1983	1984
Total Imports	$4,779.2	$3,740.2	$3,272.0	$3,112.4
Food	797.7	826.0	628.2	483.4
Industrial Raw Materials	903.8	822.4	811.9	888.3
Textile Raw Materials	222.3	173.1	201.0	220.7
Metallic Raw Materials	403.7	389.0	356.6	368.3
Other Raw Materials	277.9	260.3	254.2	299.2
Mineral Fuels	1,727.3	1,039.5	864.6	638.4
Manufactured Goods	1,045.0	826.8	868.8	1,003.5

*Figures include North African countries, which in 1984 accounted for 18.5 percent of total Japanese imports from Africa.

Source: JETRO, White Paper on International Trade

Table 5: Japan's Foreign Direct Investment in Africa, FY 1981-FY 1985*

(in millions of dollars)

	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	Cumulative March 31, 1986
Total	$573	$489	$364	$326	$172	$3,369
Liberia	466	434	323	281	159	2,455
Zaire	12	11	15	--	--	282
Nigeria	1	2	1	0	--	157
Zambia	55	20	--	22	--	142
Others	39	22	24	23	13	333

*Countries not listed by name have less than $100 million in cumulative investments.

Source: Ministry of Finance

In 1983 Japan's bilateral ODA to sub-Saharan Africa was $261.4 million -- 11.8 percent of total aid disbursements. Although the 1984 total dropped to $210.8 million (9.9 percent of the total), officials stress that the decrease does not reflect a turn away from African development needs. They note that the decrease was due to difficulties in granting loans to the region ($103.8 million in 1983 to $37.2 million in 1984). However, they stress that Japan expanded its capital grant assistance ($119 million in 1983 to $133.7 million in 1984) and technical assistance ($38.6 million in 1983 to $39.9 million in 1984). Starting with FY 1985's figures, officials expect to sustain continued increases in ODA --including loans -- to the subcontinent.

Increasingly vocal promises of aid as well as expanding Japanese multilateral assistance also indicate a growing commitment to the region. In 1984 Foreign Minister Abe pledged to increase aid by approximately $48 million during FY 1985 and to send twice as many Japanese Overseas Cooperation Volunteers to Kenya, Tanzania, Morocco, Zambia, Malawi, Ethiopia, Tunisia and Ghana by 1988. Japan is the second-ranked contributor to the African Development Bank and the African Development Fund, and participates with four other countries in the World Bank's Special Facility for Africa.

While Asia remains Japan's top priority for development assistance, Africa will probably fit into the number-two slot. Presently, Latin America, the Middle East and Africa each receive roughly 10 percent of Japan's total ODA. Observers predict, however, that the intensity of African development problems -- coupled with ODA eligibility obstacles caused by the high income levels of Middle East and Latin American countries -- make sub-Saharan Africa a promising candidate for second place.

Because the extreme poverty of the region reduces its ability to repay loans, assistance to African countries is almost exclusively in the form of grants, especially food aid and agricultural development. This was highlighted during Foreign Minister Abe's 1984 visit to Zambia, Ethiopia and Egypt, during which he promised additional emergency funds for the development of agriculture, transportation and storage facilities; urged international cooperation to eliminate the African food crisis; and said that Japan would work with nations of any political philosophy to reduce the ravages of the famine.

While the famine was at its worst, Japan's assistance consisted largely of food aid. Now that the situation has improved somewhat, the focus has shifted to agricultural development. In an effort to assist the move toward self-sufficiency, Mr. Abe proposed a "Green Revolution for Africa" -- a plan patterned after Asia's Green Revolution in the late 1960s and early 1970s. The five-part proposal includes reforestation, assistance in formulating national development plans, infrastructure improvement, support for rural development reforms and increased aid for small farmers. Mr. Abe's plan was adopted at the Bonn summit meeting in September 1985.

Japan's primary contribution will be a "Green Corps," under the direction of the Japan International Cooperation Agency. Members of the corps will be young volunteers who will plant trees near villages and cities in an attempt to restore ecological balance to the region. Other "Green Aid" efforts include funding for international agricultural research institutes, efforts to improve agricultural technology (especially high-yield seeds) and increased aid for small landholders. Japan is also trying to improve the effectiveness of aid projects by expanding evaluation and follow-up efforts, and by tying more grants to technical assistance. In 1986 JICA began a nursery training and forestry development project in Kenya. Similar technical cooperation projects include the Kilimanjaro Agricultural Development Center; a University of Zambia veterinary education program; a nursery as well as an agricultural study in Senegal; the Baigom agricultural development project in Cameroon; and the Mwea irrigation development in Kenya. All, however, face a major difficulty in that, due to Japan's lack of experience in Africa, few volunteers are well-versed in African issues or -- for Francophone countries -- fluent in French.

The major recipients of Japanese development assistance include Kenya, Ghana, Senegal, Tanzania, Zambia and Zimbabwe. But since its aid is primarily humanitarian, some assistance reaches nearly every country on the subcontinent. Nonetheless, political factors inevitably come into play. For example, the advantages of bringing Mozambique into the Western camp and Tanzania's role as a leader of the non-aligned movement are not lost on Japanese policymakers. Nor is economic strategy completely absent. Aid concessions have been used to secure natural resource supplies and to assist Japanese private investment projects that suffer from the region's economic difficulties (see Table 6).

The African debt crisis, while serious, is structurally different from that of Latin America. Nearly all outstanding Japanese loans are owed to the government, not to private lenders. Japan has taken some steps to alleviate the problem, mainly in the form of debt rescheduling. It has also instituted a program for the Least-Developed African countries whereby a matching aid grant is given for every loan installment repaid to Japan.

Table 6: Japan's Aid to Selected African Countries, 1984

(in millions of dollars)

	Grants	Technical Assistance	Loans	Total
Total	$133.69	$39.93	$37.20	$210.83
Burkina Faso	4.50	0.07	0.00	4.57
Burundi	3.97	0.12	--	4.08
Ethiopia	2.01	1.60	-1.14	2.47
Gambia	3.27	0.09	--	3.36
Ghana	6.34	2.94	3.39	12.67
Guinea	2.41	0.45	-0.14	2.71
Kenya	10.64	11.40	7.97	30.01
Liberia	1.14	1.34	1.15	3.63
Malagasy	3.29	.37	3.21	6.87
Malawi	2.78	2.51	1.11	6.40
Mauritius	3.73	0.16	-0.20	3.69
Mozambique	6.27	0.03	--	6.30
Niger	4.79	0.33	-1.61	3.51
Rwanda	2.21	0.87	--	3.07
Senegal	10.16	1.96	0.55	12.68
Somalia	2.63	0.18	0.40	3.22
Tanzania	12.87	5.41	7.78	26.06
Togo	2.59	0.04	--	2.63
Uganda	5.52	0.09	-0.33	5.28
Zaire	3.31	1.45	0.14	4.91
Zambia	14.85	3.12	8.03	26.00
Zimbabwe	7.87	0.47	9.33	17.67

Source: Annual Blue Book of Foreign Policy

Relations with South Africa

South Africa is by far Japan's most important trading partner on the continent. In 1985 it accounted for 52.1 percent of Japan's imports from Africa and bought 21.9 percent of all Japan's exports to the continent. Japan is South Africa's second-largest customer, buying platinum, chrome, asbestos, manganese, vanadium, coal and corn. Japan is also a major exporter to Pretoria, selling primarily cars and electronic equipment. The economic partnership is considered so important to both countries that South Africa has bestowed -- and the Japanese have accepted -- "honorary white" status.

Despite the close trading relationship, political tensions continue to grow between the two countries. To protest South Africa's apartheid policy, Japan has taken limited sanctions against Pretoria. Diplomatic relations exist only at the consular level. Japan also bans direct foreign investment in South Africa, forbids the export of computers to government authorities, has stopped buying the Krugerrand gold coin, and refuses to participate in athletic, cultural or educational exchanges. The Japanese government has also initiated a scholarship program for South African black students, and has instructed Japanese firms with operations in the region to give black employees the same working conditions as whites.

In an effort to reinforce the economic relationship and to dissuade Japan from adopting further sanctions, South African Foreign Minister Roelof "Pik" Botha met with his Japanese counterpart, Tadashi Kuranari, in September 1986, marking the first high-level diplomatic visit between the two countries. Mr. Botha asked for Japan's understanding of South Africa's efforts to abolish apartheid, and stressed that because trade with Japan also benefits South Africa's black majority, increased sanctions would also hurt that group. Mr. Kuranari took the occasion to protest Pretoria's racial policies and urged a halt to the recent military strikes and sanctions against neighboring states. He said that Japan would impose more stringent economic sanctions if steps to dismantle apartheid were not taken.

The visit met with mixed reactions in Japan. While government officials welcomed the opportunity to voice their opposition to Pretoria, the Japan Socialist Party and several anti-apartheid groups staged a protest during the foreign ministers' meeting, displaying signs saying "Botha Go Home" and "Pik Botha, We Aren't Honorary Whites. We Are Asians Against Apartheid."

But domestic pressures for enhanced relations with South Africa have also emerged. Members of the Japan-South Africa Parliamentarians' Friendship League stress the necessity of protecting Japanese industries by restoring full diplomatic and economic ties. The group's membership consists of businessmen as well as 40-plus members of the Liberal Democratic Party, including prime ministerial-hopeful Noboru Takeshita.

Critics charge that the sanctions now in place were in fact formulated so that trade with South Africa could continue unhindered. Investment, they say, takes place through third countries. As for the ban on computer sales, the restriction applies only to purchases by the government and the police -- not to local dealers. Moreover, they point to the fact that despite the ban on the Krugerrand, Japanese gold imports from South Africa increased over 300 percent between 1984 and 1985. And they believe that since the government did little to stop private industry from engaging in "sanctions-busting" in Rhodesia, the boycott against Pretoria will not be well enforced. This last criticism has led to the inclusion of an amendment in HR 4868 -- a measure passed this month requiring U.S. sanctions against South Africa -- that authorizes the president to limit imports from any country that "benefits from, or otherwise takes commercial advantage of" U.S. sanctions.

Japanese officials say that their position against South Africa is firmer than that of most Western countries and they emphasize their commitment to following the United States and Europe in taking additional sanctions. At the same time, while no official announcement has yet been made, Japanese government officials hint that they will impose new sanctions unilaterally this month, including an embargo on coal and iron ore purchases, and possibly measures to reinforce South Africa's isolation, such as limiting tourism and shutting down the Johannesburg office of the Japan External Trade Organization.

The Future

It appears that the fears of future oil crises and the lure of sub-Saharan natural resource supplies that were expected to lead to the long-term expansion of Japan/Africa economic relations were unfounded. All indications are that the decline already noted will continue, at least as long as raw materials are abundant and prices remain low in other parts of the world

With the recent succession of Tadashi Kuranari as foreign minister, questions have been raised as to whether Japan's increased aid to the region stemmed from Mr. Abe or from a government consensus, and what effect the transition will have on Japan's African policies. To some extent, it appears that Mr. Abe's rationale for African development aid has been institutionalized, and thus it is likely that Japan -- for political, institutional and humanitarian reasons -- will continue to make sub-Saharan Africa a priority in its foreign aid efforts.

For further information, contact Eileen Marie Doherty.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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Japan's Economy Bounces Back In Second Quarter

Led by personal consumption expenditures and housing investment, Japan's economy in the April-June quarter recovered from its January-March decline. Gross national product grew at an inflation-adjusted annual rate of 3.6 percent, compared to a 2.1 percent decline in the first three months of 1986 (see Table). The economy rose 0.9 percent with domestic demand accounting for 1.9 percentage points of growth and the external sector pushing it down by 1 percentage point.

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1984	FY 1985	July-September 1985	October-December 1985	January-March 1986	April-June 1986
Gross National Product	Y281,102.2	Y292,847.8	Y291,379.9	Y295,529.9	Y293,979.6	Y296,621.7
	(5.0%)	(4.2%)	(2.7%)	(5.8%)	(-2.1%)	(3.6%)
Personal Consumption Spending	159,100.7	163,307.6	162,777.8	163,661.5	164,664.0	166,258.8
	(2.6%)	(2.6%)	(2.2%)	(2.2%)	(2.5%)	(3.9%)
Private Residential Construction	13,688.4	14,197.8	13,881.0	14,188.1	14,539.1	14,924.8
	(0.4%)	(3.7%)	(-9.4%)	(9.1%)	(10.3%)	(11.0%)
Private Fixed Nonresidential Investment	47,342.6	53,295.3	52,981.2	54,303.4	54,492.2	54,697.0
	(10.9%)	(12.6%)	(15.4%)	(10.4%)	(1.4%)	(1.5%)
Change in Business Inventories	1,839.1	1,645.9	1,438.2	1,838.4	1,504.3	656.9
	(86.0%)	(-10.5%)	(-61.4%)	(167.0%)	(-55.2%)	(-96.4%)
Government Current Expenditures	26,654.9	27,365.9	27,192.9	27,369.9	27,819.7	28,164.7
	(2.3%)	(2.7%)	(1.7%)	(2.6%)	(6.7%)	(5.1%)
Government Fixed Investment	22,159.9	20,637.9	20,495.6	20,924.9	20,782.0	21,522.2
	(-3.0%)	(-6.9%)	(11.3%)	(8.6%)	(-2.7%)	(15.0%)
Change in Government Inventories	159.1	307.2	515.6	604.4	17.5	3,226.0
	(*)	(*)	(*)	(*)	(*)	(*)
Net External Sector	10,157.3	12,090.2	12,097.6	12,639.3	10,160.8	7,171.3
	(49.2%)	(19.0%)	(-30.6%)	(19.2%)	(-58.2%)	(-75.2%)
Exports of Goods and Services and Factor Income Received	53,609.8	54,747.6	55,077.6	54,720.5	51,844.6	52,754.6
	(15.8%)	(2.1%)	(-13.9%)	(-2.6%)	(-19.4%)	(7.2%)
Imports of Goods and Services and Factor Income Paid	43,452.4	42,657.4	42,980.0	42,081.2	41,683.8	45,583.3
	(10.0%)	(-1.8%)	(-8.3%)	(-8.1%)	(-3.7%)	(43.0%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

Despite modest nominal wage increases, personal consumption spending rose at a 3.9 percent real annual pace in the second quarter. The relative stability of consumer prices strengthened households' purchasing power. The increase in private residential construction, sustained by low interest rates, remained in the 10 percent zone for the third consecutive quarter. Government spending also boosted the economy, in contrast to its negative contribution in FY 1985, with fixed investment and current expenditures in the April-June period (the first quarter of fiscal 1986) up at a 9.2 percent annual rate.

Despite the strength of domestic demand, the Economic Planning Agency predicted that the economy, which grew 4.2 percent in FY 1985, will be unable to achieve the 4 percent target set for the current fiscal year. Exports and business investment, the pillars of the economic expansion that began in March 1983, remain sluggish. Growth in private capital spending was under 2 percent for the second consecutive quarter as manufacturers scaled back investment plans in response to falling export volumes and profits. The external sector exerted a significant drag on the economy due to a 43 percent jump in imports. Tokyo's large purchases of gold to mint commemorative coins accounted for much of the rise, however, and explain the unusually large increase in government inventories.

The government has drawn up the outlines of the long-awaited economic stimulus package to be unveiled September 19. The program will include Y3 trillion ($19.4 billion at Y155=$1.00) of additional public works spending and Y500 billion ($3.2 billion) for other projects. The package, promised by the Liberal Democratic Party in the July election campaign, is one of the largest reflationary efforts ever undertaken by the government. Part of the package will be incorporated in the supplementary budget to be submitted to the Diet in mid-October. It is expected that the increased spending will be financed through the issue of construction bonds, although the Ministry of Finance has opposed increasing the government's debt burden.

Although the package also calls for flexible monetary policy, Bank of Japan governor Satoshi Sumita continues to state that he has no plans for a fourth cut in the official discount rate, which currently stands at 3.5 percent. The central bank chief, fearing a possible rekindling of inflation, has voiced concern over recent increases in land and stock prices. Finance Minister Kiichi Miyazawa, noting that the official discount rate is at a historically low level, stated that there is room for only one more cut. The interest rate on ordinary bank deposits is now set at a meager 0.38 percent. Extraordinary care must be taken, Mr. Miyazawa said, in the timing of the discount rate cut.

Randall S. Jones

The Chips Are Down, But Prices Are Up

The July 30 U.S.-Japan agreement on semiconductor trade has succeeded in one of its goals: Japanese makers of 256K and higher-density dynamic random-access memory (DRAM) chips are no longer selling their wares at bargain-basement prices. On the contrary, current prices are so high as to have a negative impact on both American and Japanese chip makers and distributors. The book-to-bill ratio, which compares the volume of new orders to shipments, fell below

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FOREIGN DIRECT INVESTMENT IN JAPAN: 1986 UPDATE

Summary

Tokyo's continuing liberalization of goods and services markets is beginning to impact on the level of foreign direct investment in Japan. According to Finance Ministry figures for 1985, foreigners poured nearly twice as much capital as the year before into new or existing Japanese enterprises, despite a decline in the overall number of cases. While virtually all the legal barriers to foreign investment were dismantled a decade ago, only with the advent of financial market liberalization has the infrastructure to support foreign investment begun to develop. In addition, an important psychological shift appears to have taken place among foreign competitors. Even though a local presence does not guarantee success in penetrating that country's highly competitive domestic markets, it is increasingly seen as a necessary and feasible step. Despite the yen's sharp appreciation over the past year, foreign direct investment will become an increasingly important factor in Japanese economic growth.

The New Climate: Liberalization

In the past two years the Japanese government has implemented major portions of programs designed to deregulate basic industries. This has created new opportunities for foreign firms -- opportunities that demand significant investments in personnel, equipment and support. The sources of this deregulation movement are varied; however, two are central. The first is Tokyo's desire to shrink the size of the government while restructuring its regulatory powers to meet current economic conditions. Japan's national debt as a share of gross national product has grown to levels that match this country's ratio. Unlike the United States, however, Tokyo is only now coming to terms with how to refinance the debt while continuing everyday operations. A smaller bureaucracy coupled with a more vigorous economy would be a major step toward defusing the debt situation. Less regulation of basic goods, services and financial markets is seen as one way to accomplish both goals. This is a major change in Japanese economic policy. The elevation of free markets to a much higher status has clearly improved the climate for foreign investors, and has led to a more receptive attitude toward foreign participation in Japanese markets.

The second impetus to change has come from U.S.-Japan negotiations on a wide range of subjects. Although Tokyo can claim credit for many unilateral moves that improved market access for foreign firms, a number of important details were resolved only after long bilateral negotiations, including the May 1984 yen-dollar agreement and the 1985 market-oriented, sector-selective (MOSS) talks. In both cases, Tokyo was moving gradually in the desired direction. At Washington's insistence, however, schedules were accelerated and new regulations written to take foreign views into greater consideration. A closer look at several areas reveals this paradigm.

Telecommunications Equipment and Services - As part of the government's administrative reform plan, the domestic telecommunications market was opened to private firms on April 1, 1985. While this date heralded a flurry of investment activity, preparations for participating in the deregulated market had been in progress for more than a year. The allure was irresistible to many foreign firms, and particularly to American concerns. Not only did the change attract investments from such systems-oriented companies as AT&T International Inc., GTE Corp., Northern Telecom Inc. and Digital Switch Corp., but it also interested a host of firms that provide hardware components and information management services. The pull of the new market extends as far as satellites and computer software -- both U.S.-dominated fields.

Pharmaceuticals and Medical Products - Testing, certification and approvals procedures were the focus of bilateral talks in this area. U.S. companies have long been interested in the Japanese market but have recently launched a long-term campaign to beef up their position there. With simplified regulations in place, it will be easier to serve Japan's health-conscious consumers. In addition, the "greying" of the population translates into a growing market base. Despite remaining issues, therefore, an increasing number of medical products and pharmaceutical firms are opening up shop in Japan.

Electronics and Software - The presence of foreign firms in these markets is nothing new to Japan. Two developments, however, will improve the attractiveness of the Japanese market to foreign firms: Tokyo's adoption of intellectual property protection for both integrated circuit designs and computer programs similar to U.S. safeguards, which improves the confidence of foreign firms entering these highly competitive Japanese markets; and a realization by foreign firms that a presence in Japan, preferably a manufacturing operation, is absolutely critical to success inside Japan, and perhaps outside

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as well. With adequate intellectual property safeguards in place, foreign-owned companies will be less fearful of bringing their best technology to key Japanese markets.

Financial Deregulation - The May 1984 yen-dollar agreement, a milestone for both Japan and the United States, commits Tokyo to open its financial markets to greater competition. Under the accord, Japan agreed to use more free-market mechanisms and to improve the depth of the financial system and its linkages with international money markets. Subsequent talks have insured Tokyo's sustained momentum as well as sensitivity to foreign views. These moves have poked large holes in the barriers that once insulated Japan's financial markets from global influences.

Financial deregulation has both a direct and indirect effect on foreign investment. The process has directly created openings in Japan's financial community that foreign firms can fill. This is true of trust banking and securities trading, and will soon be true for offshore banking as well. It has also affected peripheral financial services, such as insurance and leasing, much to the benefit of foreign firms. These market opportunities have not gone unnoticed -- the expansion or establishment of offices of foreign financial firms has been nothing less than breathtaking. These direct consequences of financial liberalization are likely to be outweighed by the indirect effects, however.

In the past, foreign investors in Japan had to cope without the institutions and services necessary to guide basic investment decisions. Services we take for granted were not available to investors exploring Japan's markets, from financial analysis of individual companies to credit ratings and employment agencies. In addition, the attitude toward foreign investors was not always amicable. In fact, the Japanese language does not have a word for "takeover," but uses the word "hijack" in referring to an unfriendly overture. In sum, foreign investors faced a maze of obstacles that had nothing to do with government regulations.

Liberalization and economic conditions are beginning to change this climate. Investment advisory services for small as well as large clients are increasing in number. Commercial real estate companies are devoting more effort providing services tailored to foreign needs. Prodded by slow growth, prefectural governments now compete arduously to attract foreign investment. All this bespeaks a change in attitude -- a fundamental shift that will begin to break down the psychological and cultural barriers that have hindered foreign investment in the past.

The New Climate: Foreign Attitudes

This change in Japanese attitudes has been accompanied by a new view from abroad that one must be globally competitive and compete globally in order to survive in business. Given the huge size of the U.S. domestic market, it is not surprising that American firms have lagged in adopting this perception. Japan set the standard of excellence in many product areas, and in some cases American companies have responded. No longer is their goal to beat the guy across the street, but rather the guy across the ocean. Taking the fight into Japan's home territory is the next logical step. Not only does this allow a firm to keep tabs on its competitors in terms of product development, but it opens opportunities to study local production and management techniques. In addition, many firms have realized that they already have the unique or top-flight product to be successful in Japan and that the move abroad is worth the effort.

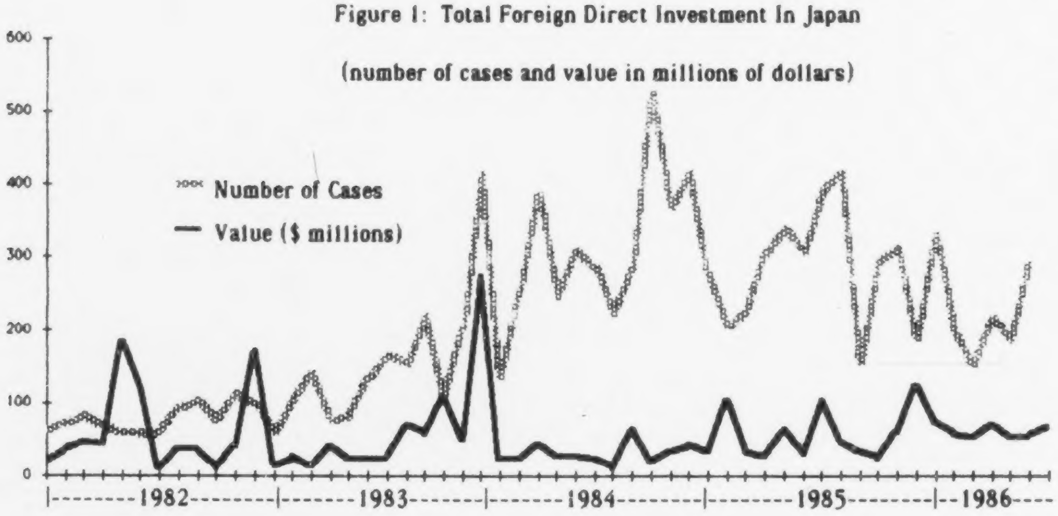
Another important psychological change in the United States is the death (albeit slow) of the "not-invented-here" syndrome. It is true that for many years the United States led the world in technology almost across the board. The emergence of Japanese as well as European competitors, however, has knocked the rose-colored glasses off U.S. noses. Following a common Japanese practice, an increasing number of American firms are establishing listening posts in Japan to gather information on technological developments. Even more important, foreign firms are opening research and development centers in Japan, just as the Japanese are beginning to do here and elsewhere. Since the pace of technological development is likely to accelerate, a presence in Japan becomes a must for foreign firms.

Finally, the practice of adopting local customs is beginning to take hold among U.S. businessmen interested in foreign investment. This is especially important in Japan, where so many business practices are heavily formalized and personal ties so important. Japanese consumers also exhibit strong cultural biases that could stymie a foreign firm's efforts to succeed in Japan. For instance, they do not buy things in units of four. Fortunately, foreign success stories are becoming more commonplace (or at least better publicized), and they all point to the importance of paying attention to local needs.

The Record for 1985

According to the Ministry of Finance, there were 3,222 foreign direct investments in Japan during FY 1985 (ended March 31, 1986) with a total value of $780 million. This far surpasses the previous fiscal year's $493 million figure, but represents a contraction in the number of ventures, down from 3,685 the previous year. Calendar year figures present a similar story: 1985's value was higher than 1984's ($770 million versus $417 million) but the case count was lower (3,490 versus 3,729). This seems to reverse a trend toward more numerous but smaller investments seen from FY 1981 to FY 1984 (see Figure 1).

It is important to note that the Finance Ministry figures that form the basis for the data in this report are drawn from the foreign investment notices filed with the ministry. Although the figures cover all sectors, including distribution, services and manufacturing, there are two major caveats. First, there is no verification of the investment by MOF officials. Given the tortuous negotiations that precede an investment, it would not be surprising to find that many prospective deals ultimately fall through. Second, the notifications are submitted in Japanese and translated into English by the ministry. We have made no effort to verify the names, value or current status of these investments. Thus the information should be construed only as an indication of trends.



Furthermore, MOF's foreign investment classification guidelines differ from standard U.S. practice. MOF considers investments valued at less than 10 percent of a company's outstanding stock or led by investment brokers as direct investments rather than portfolio investments. In fact, MOF classifies all investments over Y100,000 ($645 at Y155=$1.00) as "major" and does not even consider the percentage of capital owned. Another important difference is that MOF does not include investment by foreign subsidiaries in Japan that are funded with retained earnings or with locally obtained financing, which can be quite significant. As a result, the Japanese data can present a confusing picture.

A compilation of major investments for 1984 and 1985 reveals several significant shifts in investor behavior (see Tables 1 and 2). In contrast to aggregate investment data, MOF figures show a decline in major investments in 1985 to just under Y111 billion and 832 cases, from 1984's level of Y122 billion and 841 cases. More money from Europe offset a decline in U.S. investments, but funds from other areas of the world showed steep reductions, accounting for the overall fall.

The United States continued to account for a majority of the investment activity in Japan in 1985. With a surge of over Y4 billion ($25.8 million), Great Britain nearly doubled its share of all foreign-affiliated investments, despite recording only seven additional ventures. France and West Germany, on the other hand, cut back on investments, although much of this was offset by higher inflows from other European nations. Within the Other Europe category, it is interesting to note that the Netherlands, Ireland and Switzerland accounted for over 90 percent of the value. While funds from Hong Kong held steady, investment from the rest of the developing world fell drastically. One bright spot was hidden in the Other Asia category as Chinese investments continued to grow, hitting Y176.3 million ($1.1 million) in 1985 compared with Y27 million ($174,000) the previous year.

A major shift took place in the distribution of funds to new firms, existing firms and expanded holdings, with the first shrinking and the last ballooning. It is difficult to find reasons for the dramatic decline in new operations, particularly by American investors, given the fact that the dollar was relatively strong against the yen for most of the year. Although numerous financial and telecommunications firms made significant initial investments during 1985, it appears that medium-sized investors around the globe stayed away from Japan.

This contrasts with the action in the expanded holdings category. Buy-out fever raged among investors from the United States, Britain, Hong Kong and other European nations in 1985. The number of cases where the foreign partner raised its share of a Japanese subsidiary's stock to 100 percent nearly quadrupled from the previous year. It is unclear if this is the beginning of a new trend or simply a one-time occurrence. It does indicate confidence on the part of foreign investors that they can succeed on their own in Japan, and a more receptive attitude toward foreign ownership on the part of Japanese businessmen.

A review of investment activity by type of investor shows that individual investors retreated from the Japanese market, again for uncertain reasons. Foreign affiliates in Japan continued to plow a great deal of money into operations, although slightly less than the previous year. The figure would probably be higher if MOF included investments financed with locally raised funds, since business investment was very strong throughout 1985.

In all, the reasons for some of 1985's most surprising developments are difficult to divine. Because the data on major investments represent only a fraction of total investments, the picture may be highly skewed. For comparison, the latest Ministry of International Trade and Industry data are presented in Tables 3, 4 and 5. In general the two point to similar phenomena: a foreign business community dominated by American companies; polarization in ownership levels between minority positions and total control; and a pickup in investment activity in the past several years.

The Impact on Foreign Trade

Over the past year there has been some debate as to the impact of foreign affiliates on Japan's trade with the United States and Europe. The most recent U.S. and Japanese data provide conflicting evidence for 1982 and 1983. According to a Commerce Department study of 1982 data, Japanese affiliates of American multinational corporations exported more to the United States than they imported from it. U.S. exports associated with multinationals shipped to Japanese affiliates totaled just over $2.5 billion, while imports from Japanese affiliates of U.S. corporations came to just over $3.9 billion. The resulting $1.4 billion deficit was almost 10 percent of the red ink the United States accumulated with Japan for that year.

On the other hand, information published by the Ministry of International Trade and Industry for fiscal 1983 (ended March 31, 1984) indicates that foreign affiliates ran a trade deficit with both the United States and Europe (Table 6). With exports to the United States totaling Y273.1 billion ($1.8 billion) and imports coming in at Y421.9 billion ($2.7 billion), foreign affiliates helped to reduce Japan's trade surplus by some Y14.9 billion ($96.1 million). While both sets of data may be accurate, differences in the coverage of each survey could explain the conflicting conclusions.

It is somewhat ironic that the U.S. numbers support the Japanese government's contention that foreign affiliates in Japan actually worsen the bilateral trade imbalance, while the Japanese data seem to argue the opposite. Information from MITI will continue to provide important data so that an answer will become apparent.

Conclusion

Is investing in Japan worth the effort? An increasing number of foreign firms seem to be answering "yes." For the reasons outlined above, a foothold in Japan is being viewed as both a key competitive requirement and an important competitive asset. Although much has been made of the fact that it can take several years before a Japanese subsidiary can show a profit, foreign firms seem to perform well in comparison to other Japanese firms (see Table 7).

Is investing in Japan becoming less complicated? The affirmative also seems to apply in this case. The presence of foreign financial institutions can only enhance the atmosphere for foreign investment. In addition, the shift in Japanese policy toward more free-market mechanisms will provide increasing room to maneuver, and new attitudes toward foreign investment are surfacing in private and public circles.

The only cloud in the sky is the strong yen. While it is likely to discourage the casual investor, it appears that the balance of factors will continue to weigh in favor of investment. The potential of the noncommunist world's second-largest economy is simply too great to ignore.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Major Direct Foreign Investments in Japan by Country and Category, 1984*

(in millions of yen; share of total in parentheses)

Investor	Total		New Firms		Existing Firms		Expanded Holdings	
	Value	Cases	Value	Cases	Value	Cases	Value	Cases
United States	Y65,011.0 (53.4%)	274 (32.6%)	Y46,981.8 (66.6%)	164 (41.3%)	Y3,714.3 (27.9%)	52 (22.1%)	Y14,314.94 (40.9%)	58 (27.9%)
Canada, Central & South America	6,452.4 (5.3)	65 (7.7)	4,373.7 (6.2)	23 (5.7)	1,021.1 (5.0)	30 (13.2)	1,057.6 (3.4)	12 (5.5)
United Kingdom	7,061.1 (5.8)	73 (8.7)	2,539.6 (3.6)	24 (6.1)	3,489.8 (17.2)	38 (16.7)	1,031.7 (3.3)	11 (5.1)
West Germany	6,939.4 (5.7)	62 (7.4)	1,904.7 (2.7)	31 (7.7)	3,738.7 (18.5)	14 (6.1)	1,296.0 (4.2)	17 (7.8)
France	3,774.0 (3.1)	45 (5.4)	1,975.2 (2.8)	21 (5.4)	547.0 (2.7)	11 (4.8)	1,251.8 (4.0)	13 (6.0)
Other Europe	13,635.3 (11.2)	103 (12.2)	4,021.0 (5.7)	46 (11.6)	4,289.1 (21.2)	32 (14.0)	5,325.2 (17.2)	25 (11.5)
Hong Kong	10,226.4 (8.4)	86 (10.2)	3,668.2 (5.2)	29 (7.3)	1,840.1 (9.1)	20 (8.8)	4,718.1 (15.2)	37 (17.1)
Taiwan	3,287.1 (2.7)	40 (4.8)	1,269.8 (1.8)	27 (6.7)	638.1 (3.2)	10 (4.4)	161.7 (0.5)	3 (1.4)
Korea	730.5 (0.6)	3 (0.4)	493.8 (0.7)	1 (1.0)	236.7 (1.2)	2 (0.9)	0 (0.0)	0 (0.0)
Southeast Asia	1,826.2 (1.5)	15 (1.8)	1,128.7 (1.6)	14 (3.4)	0 (0.0)	0 (0.0)	697.5 (2.3)	1 (0.5)
Other Asia	2,556.6 (2.1)	70 (1.3)	1,481.4 (2.1)	15 (3.7)	533.6 (2.6)	15 (6.6)	541.6 (1.7)	40 (18.4)
Africa	7.2 (**)	2 (0.2)	3.1 (**)	1 (0.1)	4.1 (**)	1 (0.4)	0 (0.0)	0 (0.0)
Middle East	186.3 (0.2)	3 (0.4)	0 (0.0)	0 (0.0)	186.3 (0.9)	3 (1.3)	0 (0.0)	0 (0.0)
Total	121,743.4	841	70,543.2	396	20,238.9	228	30,961.3	217
of Which:								
Individuals	3,731.6 (3.1)	183 (21.8)	1,723.6 (2.4)	73 (18.3)	1,037.4 (6.4)	63 (26.8)	970.6 (0.1)	47 (22.6)
Subsidiaries	24,213.8 (19.9)	124 (14.7)	8,731.5 (12.4)	48 (12.1)	4,576.2 (28.2)	23 (9.8)	10,906.1 (31.2)	53 (25.5)

*Stock purchases with a value greater than Y100,000.
**Less than 0.1

Source: Ministry of Finance, International Finance Bureau, Foreign Capital Division.

Table 2: Major Direct Foreign Investments in Japan by Country and Category, 1985*

(in millions of yen; share of total in parentheses)

Investor	Total		New Firms		Existing Firms		Expanded Holdings	
	Value	Cases	Value	Cases	Value	Cases	Value	Cases
United States	Y59,657.7 (53.8%)	288 (34.6%)	Y11,848.6 (52.7%)	175 (45.8%)	Y9,709.3 (50.0%)	57 (23.5%)	Y38,099.84 (55.2%)	56 (27.1%)
Canada, Central & South America	4,551.9 (4.1)	62 (7.5)	1,223.9 (5.4)	14 (3.7)	1,558.4 (8.0)	30 (12.3)	1,769.6 (2.6)	18 (8.7)
United Kingdom	11,226.2 (10.1)	80 (9.6)	1,905.8 (8.5)	29 (7.6)	2,084.2 (10.7)	41 (16.9)	7,236.2 (10.5)	30 (14.5)
West Germany	1,883.1 (1.7)	38 (4.6)	1,411.5 (6.3)	22 (5.6)	117.5 (0.6)	10 (4.1)	354.1 (0.5)	6 (2.9)
France	2,856.2 (2.6)	60 (7.2)	437.8 (1.9)	25 (6.5)	1,655.4 (8.5)	21 (8.6)	763.0 (1.1)	14 (6.8)
Other Europe	17,584.3 (15.9)	125 (15.0)	3,623.3 (16.1)	43 (11.3)	1,690.1 (8.7)	40 (16.5)	12,270.9 (17.8)	42 (20.2)
Hong Kong	10,553.7 (9.5)	51 (6.1)	585.3 (2.6)	18 (4.7)	2,134.5 (11.0)	14 (5.8)	7,833.9 (11.3)	19 (9.2)
Taiwan	442.9 (0.4)	29 (3.5)	295.2 (1.3)	17 (4.5)	95.6 (0.5)	5 (2.1)	52.1 (0.1)	7 (3.4)
Korea	73.0 (**)	5 (0.6)	60.0 (0.3)	4 (0.3)	13.0 (0.1)	4 (1.6)	0 (0.0)	0 (0.0)
Southeast Asia	393.8 (0.3)	19 (2.2)	292.4 (1.3)	9 (2.4)	76.2 (0.4)	8 (3.3)	25.2 (**)	2 (1.0)
Other Asia	1,220.2 (1.1)	45 (5.4)	535.5 (2.4)	23 (6.0)	38.9 (0.2)	10 (4.1)	645.8 (0.9)	12 (5.8)
Africa	0.2 (**)	1 (0.1)	0 (0.0)	0 (0.0)	0 (0.0)	0 (0.0)	0.2 (**)	1 (0.5)
Middle East	483.3 (0.4)	9 (1.1)	250.8 (1.1)	6 (1.6)	232.5 (1.2)	3 (1.2)	0 (0.0)	0 (0.0)
Total	110,926.5	832	22,470.1	382	19,405.6	243	69,050.8	207
of which:								
Individuals	1,463.5 (1.3)	120 (14.4)	737.0 (0.3)	62 (16.2)	216.5 (1.1)	40 (16.5)	510.0 (0.1)	18 (8.7)
Subsidiaries	21,742.9 (19.6)	112 (13.5)	2,316.3 (10.3)	52 (13.6)	3,421.2 (17.6)	32 (13.2)	16,005.4 (23.2)	28 (13.5)

* Stock purchases with a value greater than Y100,000.
** Less than 0.1

Source: Ministry of Finance, International Finance Bureau, Foreign Capital Division.

Table 3: Japanese Affiliates of Foreign Firms, Industry by Country, FY 1983

(number of companies and share of total)

	Manufacturing															
	Total		Chemicals		Nonelectric Machinery		Electric Machinery		Commerce		Services		Other		Total	
Country	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share
United States	293	58.6%	58	62.4%	54	54.5%	62	74.7%	110	28.6%	53	55.2%	17	41.5%	473	46.3%
United Kingdom	28	5.6	2	2.2	5	5.1	1	1.2	29	7.6	8	8.3	1	2.4	69	6.8
France	20	4.0	5	5.4	1	1.0	1	1.2	19	4.9	3	3.1	1	2.4	43	4.2
West Germany	42	8.4	8	8.6	12	12.1	6	7.2	34	8.9	3	3.1	3	7.3	82	8.0
Switzerland	33	6.6	9	9.7	6	6.1	3	3.6	35	9.1	5	5.2	0	0.0	73	7.1
Total Europe	170	34.0	30	32.3	38	38.4	17	20.5	185	48.2	27	28.1	12	29.3	394	38.6
Total Asia	19	3.8	4	4.3	3	3.0	1	1.2	54	14.1	8	8.3	10	24.4	91	8.9
Total	500	100.0	93	100.0	99	100.0	83	100.0	384	100.0	96	100.0	41	100.0	1,021	100.0

Table 4: Japanese Affiliates of Foreign Firms, Industry by Participation Rate, FY 1983

(number of companies and share of total)

	Manufacturing															
	Total		Chemicals		Nonelectric Machinery		Electric Machinery		Commerce		Services		Other		Total	
Foreign Ownership	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share
Up to 50 percent	214	42.8%	57	61.3%	43	43.4%	24	28.9%	79	20.6%	13	13.5%	8	19.5%	314	30.8%
50 to 100 percent	96	1.92	10	10.8	21	21.2	14	16.9	83	21.6	17	17.7	12	29.3	208	20.4
100 percent	190	38.0	26	28.0	35	35.4	45	54.2	222	57.8	66	68.8	21	51.2	499	48.9
Total	500	100.0	93	100.0	99	100.0	83	100.0	384	100.0	96	100.0	41	100.0	1,021	100.0

Table 5: Japanese Affiliates of Foreign Firms, Industry by Date of Establishment, FY 1983

(number of companies and share of total)

	Manufacturing															
	Total		Chemicals		Nonelectric Machinery		Electric Machinery		Commerce		Services		Other		Total	
Date	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share	Cases	Share
Before FY 1966	136	27.2%	31	33.3%	22	22.2%	14	16.9%	76	19.8%	7	7.3%	9	22.0%	228	22.3%
FY 1967-FY 1972	95	19.0	24	25.8	22	22.2	11	13.3	64	16.7	13	13.5	2	4.9	174	17.0
FY 1973-FY 1978	126	25.2	21	22.6	33	33.3	20	24.1	127	33.1	37	38.5	16	39.0	306	30.0
FY 1979-FY 1983	143	28.6	17	18.3	22	22.2	38	45.8	117	30.5	39	40.6	14	34.1	313	30.7
Total	500	100.0	93	100.0	99	100.0	83	100.0	384	100.0	96	100.0	41	100.0	1,021	100.0

Source: Ministry of International Trade and Industry

Table 6: Role of Foreign Affiliates in Japan's Foreign Trade, FY 1983

(in millions of yen)

	Total Trade			With United States			With European Community		
	Exports	Imports	Balance	Exports	Imports	Balance	Exports	Imports	Balance
Manufacturing	Y560,492	Y3,938,626	Y-3,378,134	Y170,873	Y327,239	Y-156,366	Y37,746	Y135,101	Y-97,355
Food Products	462	25,960	-25,498	3	10,174	-10,171	0	2,177	-2,171
Textiles	4,686	295	4,391	0	101	-101	0	194	-194
Lumber and Wood Products	517	331	187	0	0	0	0	176	-176
Pulp and Paper	940	11,097	-10,157	0	8,733	-8,733	73	243	-170
Printing and Publishing	1	60	-59	0	0	0	0	0	0
Chemicals	68,868	114,719	45,851	14,322	46,820	-32,498	7,099	51,405	-44,306
Pharmaceuticals	12,545	119,044	-106,499	1,491	31,559	-30,068	286	22,843	-22,557
Oil and Petroleum Products	60,884	3,236,579	-3,175,695	38,939	827	38,112	1,333	18,118	-16,785
Rubber Products	1,633	479	1,154	0	248	-248	0	90	-90
Glass and Mineral Products	3,003	2,520	483	2,034	105	1,929	0	1,893	-1,893
Steel	1,478	835	643	0	0	0	0	0	0
Nonferrous Metals	40,700	74,141	-33,441	1,506	77	1,429	0	95	-95
Metal Products	2,272	1,769	503	29	1,554	-1,525	0	0	0
Nonelectric Machinery	85,230	56,662	28,568	6,037	9,494	-3,457	8,633	22,946	-14,313
Electric Machinery	222,251	229,927	-7,676	100,503	189,824	-89,321	5,376	1,463	3,913
Transporation Equipment	8,216	2,108	6,108	3,932	1,574	2,358	13	386	-373
Precision Machinery	42,731	44,701	-1,970	2,077	11,069	-8,962	14,878	12,052	2,826
Other	4,025	17,390	13,365	0	15,110	-15,110	55	1,026	-971
Commerce	373,220	853,973	-480,753	101,094	88,245	12,849	349,17	147,807	-112,890
Services	7,271	9,827	-2,556	1,086	5,773	-4,687	1,607	1,592	15
Other	3,471	904	8,567	74	666	-592	76	83	-07
Total	950,454	4,803,300	-3,852,876	273,127	411,923	-148,796	74,346	284,583	-210,237

Source: Ministry of International Trade and Industry

Table 7: Foreign Affiliates in Japan, FY 1983

(in millions of yen)

	Sales	Ordinary Profit	Profit to Sales Ratio	Total Assets	Equity	Employees (thousands)	New Technology Introductions
All Industries							
Total	Y9,209,682	Y169,236	1.8%	Y5,968,002	16.6%	29,158	1,073
Foreign	135,683	4,810	3.5	75,590	24.1	140	149
Ratio	1.5%	2.8%		1.3%		0.5%	13.9%
Manufacturing							
Total	2,985,821	86,564	2.9	2,196,672	23.6	1,555	n.a.
Foreign	87,029	3,763	4.3	58,306	26.3	115	n.a.
Ratio	2.9%	4.3%		2.7%		1.0%	n.a.
Non-Petroleum Manufacturing							
Total	2,820,122	85,090	3.0	2,097,649	24.4	11,498	n.a.
Foreign	32,278	2,606	6.8	31,529	37.7	106	n.a.
Ratio	1.4%	3.1%		1.5%		0.9%	n.a.
Commerce							
Total	4,270,911	32,321	0.8	1,704,390	12.5	7,312	n.a.
Foreign	46,974	971	2.1	14,509	16.5	19	n.a.
Ratio	1.1%	3.0%		0.9%		0.3%	n.a.

Source: Ministry of International Trade and Industry

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U.S.-U.S.S.R. Summit Leaves Japan-Soviet Picture Unclear

The outcome of the U.S.-U.S.S.R. summit in Iceland October 11-12 has added a new twist to the anticipated meeting in Tokyo between Prime Minister Yasuhiro Nakasone and Soviet leader Mikhail Gorbachev. The abrupt conclusion of the Reagan-Gorbachev meeting without agreement on cutbacks in strategic nuclear forces makes the timing of Mr. Gorbachev's trip to Japan a delicate matter. While there are both advantages and drawbacks to an early meeting, the collapse of the Iceland talks might reduce the incentives in the short term and favor delay ~~until well~~ into 1987.

While Japanese officials had pressed for a Nakasone-Gorbachev meeting before the end of the year when they discussed the matter at the United Nations in September, Soviet officials declared that more pressing matters with the United States demanded attention and that at best a session could not be perceived as undercutting the possibilities of a U.S.-U.S.S.R. agreement on intermediate-range nuclear forces by insisting on a particular level of reductions in Soviet Asia.

Peking's reaction to the Soviet offer is also important since the SS-20s presumably would have remained targeted primarily at China, leaving in question the implicit U.S. commitment to that nation. Even in this case, however, resentment might have been limited since SS-20 reductions would have been traded for delayed SDI deployment, a plus in the minds of Chinese analysts.

The upshot is that the developments in Iceland have increased the sensitivity of the anticipated Nakasone-Gorbachev meeting. Representatives of both the American and Soviet governments are en route to Tokyo to brief officials there, indicating the importance of Japan and its respective bilateral relationships with the two countries. Nevertheless, the present state of U.S.-Soviet relations makes the timing of the Japan-Soviet session especially delicate.

Michael W. Chinworth

The Effect Of The Yen's Appreciation On Japanese Export Prices

The decline in the dollar during the past 18 months has failed to stem the expanding U.S. trade deficit. One obvious reason is that the depreciation of a currency first worsens a country's trade balance before it alters the volume of trade (the J-curve effect). But a second factor is that the prices of many imported goods do not fully reflect the currency changes that have taken place. At least over the short run, many foreign producers prefer to cut costs and sacrifice profits rather than lose market share by raising prices the full amount of the currency changes. Japanese cost-cutting efforts have been aided by less expensive industrial inputs, particularly oil.

Japanese exporters have passed on only half of the yen's 47.1 percent rise against the dollar in the form of price increases in the 10 months from September 1985 (see Table). This is substantially less than the two-thirds hike in the February-November 1978 period, when the yen appreciated 30.6 percent. One reason for this is that with relatively low inflation in 1985-86, price increases are more likely to reduce market share. Inflation in the United States is in the 3 percent zone this year, for example, compared to 7.7 percent in 1978. Moreover, three years of record or near-record profits have allowed Japanese industry to hold the line on price increases.

Of the 14 industries for which data are available in both periods, 11 passed on a smaller percentage of the yen appreciation in 1985-86 than in 1978. One explanation is that many of these industries face increased competition, particularly from the newly industrialized countries of Asia. Automotive manufacturers in 1978, for example, passed on almost 90 percent of the yen's appreciation. As of July 1986, in contrast, that figure was only 57.6 percent. And much of the increase apparently occurred outside the U.S. market; the prices of Japanese cars have reportedly risen only about 15 percent in this country (a 32 percent pass-on ratio). Steel and ships, which had the lowest price increases, face stiff competition, particularly from Korea, as well as stagnant demand.

Percent of Yen's Appreciation Passed on in Export Prices*

Industry	February-November 1978	September 1985-July 1986
Clothing	79.6%	40.4%
Organic Chemicals	25.5	28.8
Inorganic Chemicals	n.a.	10.5
Steel	80.2	4.7
Nonferrous Metals	71.2	15.0
Metal Products	83.1	43.4
Nonelectric Machinery	59.2	71.4
Data Processing Equipment	n.a.	58.7
Electric Machinery	74.5	56.5
Color Television Sets	57.3	48.9
Radio Receivers	69.3	51.4
Other Telecommunications Equipment	n.a.	51.1
Semiconductors and Electronic Tubes	n.a.	18.4
Integrated Circuits	n.a.	27.6
Motor Vehicles	89.3	57.6
Motorcycles	83.8	55.4
Ships	21.5	10.2
Precision Instruments	82.8	47.8
Cameras	67.0	70.6
Copiers	n.a.	78.4
Video Cassette Recorders	n.a.	15.3
Total Exports	66.3	49.3

*The yen appreciated 30.6 percent against the dollar during the February-November 1978 period and 47.1 percent between September 1985 and July 1986 based on the conversion rates used for customs clearance.

Source: Calculated from The Summary Report: Trade of Japan

The considerable variation by industry is due to factors other than the extent of foreign competition. The amount of yen appreciation passed on by exporters of basic industrial intermediates, such as steel and nonferrous metals, was especially low. In some finished products, the reputation of well-known Japanese brand names has permitted larger price increases. Producers of cars, cameras and copiers have been able to pass on a relatively high percentage of the yen's appreciation.

The failure of many exporters in Japan and elsewhere to raise prices by the full amount of the currency changes has left them open to dumping charges. Timken Co., one of the world's largest producers of roller bearings, used this argument in filing dumping charges against Japanese manufacturers. If the Commerce Department concludes that Japanese makers are selling products here at less than fair value because they have not made appropriate adjustments in export prices, more complaints like Timken's can be expected.

Randall S. Jones

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JEI

REPORT

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JAPAN'S FOREIGN AID POLICY: 1986 UPDATE

Summary

Japan continues to emphasize the need to expand aid programs so they are commensurate with its role as a global economic power. In 1986 it launched a plan that would provide more than $40 billion in official development assistance over the next seven years as well as improve the quality of its overseas programs. Thus Japan is likely to become firmly established as the second-largest ODA donor, a position it reached in 1984 before dropping back to third place last year. The drop was attributable more to the timing of multilateral contributions than to a shift in priorities, however.

As Japan's global political and economic role has expanded, the rationale for ODA programs has become more complex. The promotion of economic development abroad, commercial gain, strategic motivations, humanitarianism and global interdependence all play a part in determining the scope and direction of ODA outlays. Government statements on aid policy also place more emphasis on the importance of coordinating government and private initiatives in third world areas. Increased foreign direct investment, the expanding number of non-governmental aid groups and continued popular support for ODA efforts all indicate a growing number of participants in Japan's aid programs. In the future, ODA outlays are likely to increase further as pressures abroad and at home continue to emphasize Japan's role as a global leader as well as its need to contribute to world prosperity.

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Overview of Japan's Aid Policies

Japan's commitment to foreign aid has undergone a series of changes since Tokyo's first aid initiative to India in the late 1950s. According to aid experts William L. Brooks and Robert M. Orr,[1] there have been four distinct stages in aid policy. From the mid-1950s until approximately 1965, Tokyo's aid took the form of war reparations. The 1960s saw primarily tied aid (economic assistance in exchange for agreement to buy Japanese products) for export promotion, while the oil crisis of 1973 led to considerations of economic interdependence as Japan turned its attention to resource-rich countries as well as to those nations located along important shipping routes. Finally, beginning in 1980, development assistance took on a two-fold focus: an emphasis on alleviating poverty and expanding aid to those developing countries vital to the Western alliance's overall strategic concerns.

In the infant stages of Tokyo's aid programs, Japan considered itself a developing country; accordingly, the bulk of aid flows consisted of export credits and private efforts. Official loans were placed at near-commercial rates, aid was heavily tied, and the primary emphasis was on technical assistance. From the beginning Asia was the primary recipient of aid -- an outgrowth of the fact that reparations went to Asian countries, the accessibility of Asian markets, a shared cultural heritage, and the importance Japan placed on enhancing regional stability.

With the advent of the energy crises of the 1970s, Japan reassessed its Asia focus. Overtures to resource-rich countries marked the beginning of aid globalization, although Asia retained its number-one status. This process was expedited in the late 1970s when strategic considerations prompted by political crises in such places as Iran and Afghanistan as well as heightened criticism of Japan's tied-aid policies led Tokyo to improve the quantity, regional distribution and terms of its aid flows. Additionally, a "basic human needs" approach to ODA was adopted in the 1980s to focus on improving the conditions of the poor rather than attempting to narrow the differences between rich and poor countries through large-scale projects. To do so, Tokyo selected four areas of emphasis: rural and agricultural development; development of new and renewable energy sources; human resource development; and improvement of small and medium-sized businesses. In short, the rationale, recipients and scope of Tokyo's aid programs have expanded along with Japan's global role.

Tokyo's intention to increase its aid flows to the developing world has been signaled by a series of aid-doubling plans. In 1977 Japan pledged to double its aid disbursements within five years. The government easily achieved its goal, raising outlays from $1.4 billion in 1977 to $3.3 billion in 1980 and increasing the grant and technical assistance elements of aid. Encouraged by the success of the initiative, then-Prime Minister Zenko Suzuki announced in 1981 a new medium-term plan to double the level of aid during the 1981-85

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[1] William L. Brooks and Robert M. Orr Jr., "Japan's Foreign Economic Assistance," Asian Survey, XXV, No. 3 (March 1985), p. 323.

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period. However, a slowdown in domestic growth brought fiscal austerity to Japan, and together with a sharp depreciation of the yen made it impossible to reach the $21.4 billion aggregate goal by the end of 1985. Actual disbursements, which are measured in dollars, amounted to $18.1 billion, or approximately 85 percent of the goal. If the yen had held steady [illegible] near its average January 1981 rate of Y202=$1.00 -- when the target was set -- the aid goal would have been met, according to Foreign Ministry officials.

In spite of the second plan's setback, Tokyo quickly announced the Third Medium-Term Target. In September 1985 the cabinet approved a plan to disburse more than $40 billion over the 1986-92 period. Tokyo points out that to meet this goal, the ODA budget will have to be expanded at an annual average rate of 10.4 percent, while the second doubling plan could have been met through yearly increases of 8.7 percent. Moreover, the new goal stresses not just increased quantities of aid but also "effective and efficient implementation." Five paths to improve the quality of aid have been selected: improved implementation procedures; better coordination between technical assistance and financial allocations; specific evaluation of aid projects; improved coordination with private-sector initiatives; and cooperation with other donor countries and international organizations.

The new focus on improving the quality of aid is highlighted by several recent initiatives. For example, the Advisory Committee on the Effective Implementation of ODA, formed in April 1985 by then-Foreign Minister Shintaro Abe, suggested that project evaluation efforts could be improved. Consequently, while Tokyo has stated that regular audits of aid programs could threaten the sovereignty of recipient countries, a decision was made to establish independent project evaluation groups. A new emphasis will also be placed on the environmental impact of Japan's aid programs, a decision made in September 1986 in response to some complaints by developing countries about the "export of pollution." Moreover, the government has set up a panel to compile a handbook on prospects for the Environmental Agency's international environmental cooperation efforts.

In keeping with its basic human needs emphasis, Tokyo has broadened its capacity to respond to large-scale natural disasters. The government points proudly to its aid efforts during the 1985 earthquake in Mexico and the volcano eruption in Colombia. Tokyo dispatched its disaster relief medical team to Mexico, donated $1.25 million in assistance and provided $50 million in emergency financing. The same group was also sent to Colombia, along with former members of the Japan Overseas Cooperation Volunteers. Japan also provided $1.25 million to Colombia as well as $50,000 to the United Nations Disaster Relief Organization. Moreover, the 1986 ODA budget allocated funds to establish an organization to respond to natural disasters. In April the International Emergency Relief System was inaugurated for this purpose.

Japan's ODA Efforts in 1985

Tokyo's official development assistance in 1985 totaled $3.8 billion, a 12.1 percent decrease from the 1984 figure of $4.3 billion (see Table 1) -- dropping Japan back to third place among donor countries. (In 1984 Japan had surpassed France to become the number-two donor.) Japanese aid officials emphasize, however, that the setback reflected the cyclical nature of multilateral contributions rather than any long-term change in aid policy. Funding

Table 1: Total Net Flow of Financial Resources from Japan to Developing Countries and Multilateral Agencies, 1981-85

(in millions of dollars)

Type of Transaction	1981	1982	1983	1984	1985	Percent Change 1984/85
I. Official Development Assistance (ODA)	$3,171	$3,023	$3,761	$4,319	$3,797	-12.1%
Change Over Previous Year	-4.0%	-4.7%	24.4%	14.8%	-12.1%	
ODA/GNP Ratio	0.28%	0.28%	0.33%	0.34%	0.29%	
A. Bilateral Assistance	2,260	2,367	2,425	2,427	2,557	5.3
1. Grants	810	805	993	1,064	1,185	11.4
a. Grant Assistance	432	412	535	543	636	17.1
b. Technical Assistance	378	393	458	521	549	5.4
2. Development Lending and Capital	1,450	1,562	1,432	1,363	1,372	0.6
B. Grants, Capital Subscription and Loans to Multilateral Agencies	911	656	1,336	1,891	1,240	-34.4
II. Other Official Flows (OOF)	3,023	2,914	1,954	743	-302	---
A. Export Credits (over one year)	1,410	850	472	493	-152	---
B. Direct Investment Finance and Other	1,490	2,095	1,442	380	-1	---
C. Transactions with Multilateral Agencies at Market Terms	123	-31	41	-130	-148	---
III. Private Flows (PF)	6,011	2,929	2,918	9,968	9,332	-6.4
A. Direct Investments	2,426	364	433	1,489	1,046	-29.8
B. Export Credits (over one year)	712	-1,762	-2,069	-655	-994	---
C. Other Bilateral Securities and Claims	1,273	2,799	2,339	6,828	6,705	-1.8
D. Multilateral Private Flows	1,600	1,529	2,215	2,306	2,575	11.7
IV. Grants by Voluntary Agencies	27	23	30	41	101	149.0
Total	12,231	8,889	8,663	15,070	12,928	-14.2
Change Over Previous Year	80.8%	-27.3%	-2.5%	74.0%	-14.2%	---
As Percentage of GNP	1.09%	0.84%	0.75%	1.20%	0.97%	---
For Reference						
Total Export Credits	2,123	-913	-1,597	-162	-1,146	---
Total Direct Investments and Other	3,916	2,458	1,874	1,869	1,044	-44.1

Notes: 1. Net disbursement basis.
2. Due to rounding, the figures do not necessarily add up to the totals.

Source: Ministry of Foreign Affairs

for multilateral institutions recorded a 34.4 percent drop, primarily because Japan made a special contribution to the International Development Agency in 1984 and subscribed to a special replenishment of the World Bank that year, pushing up the multilateral ODA contribution by 41.6 percent in 1984. As a result of the decrease in 1985, Tokyo's ODA/GNP ratio was only 0.29 percent compared with 1984's 0.34 percent. Japan ranked 15th in terms of ODA/GNP last year, when the Development Assistance Committee average was 0.35 percent -- significantly less than the U.N.-recommended 0.7 percent ratio (see Tables 2 and 3).

Viewing Japan's multilateral assistance in this context somewhat obscures its achievements in 1985. Bilateral aid rose to nearly $2.6 billion, with grants up 17.1 percent and technical assistance 5.4 percent. Direct investment financing and export credits decreased dramatically, reflecting Tokyo's commitment to improve the terms of aid flows to developing countries.

Prospects for future ODA outlays are largely contingent on the broad trend of Japanese economic policy, as illustrated by the budget disputes between the Ministry of Finance and the Foreign Ministry over the priority to be accorded the policy of fiscal austerity. While aid and defense allocations are the only two major categories that have been consistently exempted from cuts in discretionary spending, there is some disagreement as to how much the aid budget should be expanded. The Finance Ministry fought to hold the growth in the FY 1986 ODA budget to 6 or 7 percent, but eventually accepted 10 percent. The Foreign Ministry had argued that double-digit growth was necessary to ease foreign criticism of Japan's trade surpluses, meet foreign expectations of Tokyo's aid, and achieve the goal of the Third Medium-Term Target.

In preliminary budget guidelines for FY 1987, ODA allocations are slated for a 7.5 percent hike; nonetheless, the aid budget is likely to receive the largest increase of all discretionary budget items. Officials point out, moreover, that because of the yen's appreciation, the dollar value of Tokyo's contribution will increase by more than 10 percent. (The effects of appreciation did not show up in the 1985 figures, which were calculated at an average Y238.54=$1.00 -- or virtually the same conversion factor used in 1984.)

Comprehensive Security and Interdependence

Just as the terms of the Third Medium-Term Target reflect the need to expand aid efforts, so too does Japan's increased global presence reflect the complexity of reasons for Tokyo's aid policies. Economic motivations, security considerations, increased awareness of global interdependence, a desire to live up to its position as a world power and humanitarian goals all play a part in Japan's ODA policies.

Prior to the 1980s the government only acknowledged economic reasons for aid distribution. An official rationale for the ODA program was adopted in 1980, when then-Prime Minister Masayoshi Ohira embraced "comprehensive national security" -- that is, the consideration of military and non-military factors in security issues -- as national policy. In this way, he linked aid to Japan's long-term strategy for defense, energy and food -- albeit in a non-military way. Because policy was "comprehensive," aid was also designated for international security, especially for countries in the Western alliance. As part of the new policy, the Japanese government pledged to give economic assistance

Table 2: ODA as Percentage of GNP for DAC Countries, 1981-85

(in millions of dollars)

1985 Rank		1981 Amount	1981 Percent of GNP	1982 Amount	1982 Percent of GNP	1983 Amount	1983 Percent of GNP	1984 Amount	1984 Percent of GNP	1985 Amount	1985 Percent of GNP	Percent Change 1984/85
1	Norway	$467	0.82%	$559	0.99%	$584	1.09%	$543	1.03%	$555	1.00%	2.3%
2	Netherlands	1,510	1.08	1,472	1.08	1,195	0.91	1,268	1.02	1,135	0.91	-10.5
3	Sweden	916	0.83	987	1.02	754	0.84	741	0.80	841	0.86	13.4
4	Denmark	405	0.73	415	0.76	395	0.73	449	0.85	440	0.80	-2.1
5	France*	4,022	0.71	4,034	0.75	3,815	0.74	3,788	0.77	4,022	0.79	6.2
6	Belgium	574	0.59	499	0.59	487	0.60	442	0.57	430	0.53	-2.7
7	Australia	649	0.41	882	0.57	753	0.49	777	0.45	749	0.49	-3.6
7	Canada	1,187	0.43	1,197	0.41	1,429	0.45	1,625	0.50	1,638	0.49	0.8
9	West Germany	3,182	0.46	3,152	0.48	3,176	0.48	2,782	0.45	2,935	0.47	5.5
10	Finland	135	0.28	145	0.30	153	0.32	178	0.36	211	0.39	18.5
11	Austria	317	0.48	235	0.35	158	0.23	181	0.28	248	0.38	37.0
12	United Kingdom	2,194	0.43	1,800	0.37	1,610	0.35	1,430	0.33	1,531	0.34	7.1
13	Switzerland	236	0.24	252	0.25	320	0.31	286	0.30	301	0.31	5.3
13	Italy	670	0.19	811	0.24	833	0.24	1,133	0.33	1,099	0.31	-3.0
15	Japan	3,171	0.28	3,023	0.28	3,761	0.32	4,319	0.34	3,797	0.29	-12.1
16	New Zealand	67	0.29	65	0.28	61	0.28	55	0.25	54	0.25	-1.0
17	United States	5,760	0.20	8,202	0.27	8,055	0.24	8,711	0.24	9,555	0.24	9.7
17	Ireland	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	35	0.22	39	0.24	13.4
DAC Total		25,461	0.35	27,730	0.38	27,540	0.36	28,743	0.36	29,580	0.35	2.9

*Including overseas territories and prefectures.

Source: Organization for Economic Cooperation and Development

Table 3: ODA of Major Donor Countries, 1981-85

(in millions of dollars)

1985 Rank	Country	1981	1982	1983	1984	1985	Share of Total DAC ODA 1985
1	United States	$5,760	$8,202	$8,055	$8,711	$9,555	32.3%
2	France*	4,022	4,034	3,815	3,788	4,022	13.6
3	Japan	3,171	3,023	3,761	4,319	3,797	12.8
4	West Germany	3,182	3,152	3,176	2,782	2,935	9.9
5	Canada	1,187	1,197	1,429	1,625	1,638	5.5
6	United Kingdom	2,194	1,800	1,610	1,430	1,531	5.2
DAC Total		25,461	27,730	27,540	28,743	29,580	100.0

*Including overseas territories and prefectures.

Source: Organization for Economic Cooperation and Development

to "countries bordering conflict areas." Three countries -- Turkey, Pakistan and Thailand -- were deemed to fit this category in 1980, and each received increased aid.

The term "countries bordering conflict areas" may have been too confrontational for a country pledged to world peace, however. In 1981 Prime Minister Suzuki adopted a new phrase to describe strategic aid: "those areas which are important for the maintenance of peace and stability in the world." This designation is still listed in summaries of Japan's aid philosophy. Subsequently, Japan has increased its assistance to strategically important countries, including Egypt, Pakistan, Jamaica, South Korea, Oman, Sudan, Zimbabwe, North Yemen, Kenya, the People's Republic of China and ASEAN (the Association of Southeast Asian Nations). Moreover, it has withheld aid as a diplomatic sanction -- for example, to Vietnam.

Some of these initiatives have been at the request of the United States; others have required little persuasion. However, Japanese officials do not agree as to what place strategic considerations have in aid flows. There are Liberal Democraty Party members who deny that aid is given for strategic reasons at all. For example, while the front-line position of Thailand is regarded by some party officials as justification for assistance, others argue that humanitarian reasons exist for aiding the refugee-filled country. Still others observe that the interdependence between Japan and Thailand prompts the aid.

The level of disagreement among LDP officials highlights the sensitive nature of strategic aid. The Diet has restrictions against using aid directly for military and security assistance; consequently, Tokyo has rejected specific security-related aid requests. Thus, Japan refuses to give technical or economic cooperation if it is either applicable to military purposes or (in relation to countries at war) if it is capable of escalating the conflict. Within the bureaucracy, the Foreign Ministry is the most supportive of using aid for strategic reasons; other ministries make few attempts to actively support comprehensive national security. However, an unofficial consensus does exist in the government that annual increases in the ODA budget should be greater than those in the defense budget.

According to aid expert Dennis Yasutomo,[2] given Japan's hesitancy to cite strategic reasons for assistance, the government in recent years has been more likely to empasize interdependence and humanitarianism as motivations for aid. Interdependence differs from comprehensive security in that it is broader, taking into account nonstrategic geographic, historical, political and economic factors.

Regional Distribution of Aid

As Table 4 indicates, Japan's development assistance emphasizes Asia, specifically the ASEAN countries, the People's Republic of China and South Korea. Stability in Asia is considered vital to Japan's long-term security. In fact, by the end of the 1970s, a 7-1-1-1 formula was institutionalized in

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[2] Dennis Yasutomo, The Manner of Giving (Lexington, Massachusetts: Lexington Books, 1986), Chapter 4.

Table 4: Japan's ODA by Region, 1981-85

(in millions of dollars)

Year	Total	Asia	Middle East	Africa	Latin America	Europe	Oceania	Unallocable
1981	$2,260 (100.0%)	$1,605 (71.0%)	$190 (8.4%)	$211 (9.3%)	$177 (7.8%)	$-2 (-0.1%)	$19 (0.9%)	$62 (2.7%)
1982	$2,367 (100.0%)	$1,624 (68.6%)	$194 (8.2%)	$268 (11.3%)	$184 (7.8%)	$-3 (-0.1%)	$23 (1.0%)	$77 (3.2%)
1983	$2,425 (100.0%)	$1,614 (66.5%)	$150 (6.2%)	$287 (11.8%)	$241 (9.9%)	$23 (1.0%)	$18 (0.7%)	$93 (3.8%)
1984	$2,427 (100.0%)	$1,594 (65.7%)	$249 (10.3%)	$211 (8.7%)	$229 (9.4%)	$38 (0.1%)	$25 (1.0%)	$117 (4.8%)
1985	$2,557 (100.0%)	$1,732 (67.7%)	$201 (7.9%)	$252 (9.9%)	$225 (8.8%)	$1 (0.0%)	$24 (0.9%)	$122 (4.8%)

Note: Net disbursement basis.

Source: Ministry of Foreign Affairs

Table 5: Major Recipients of Japan's ODA, 1981-85

(in millions of dollars)

1981		1982		1983		1984		1985	
Country	Amount	Country	Amount	Country	Amount	Country	Amount	Country	Amount
Indonesia	$300	China	$369	China	$350	China	$389	China	$388
South Korea	296	Indonesia	295	Thailand	248	Malaysia	245	Thailand	264
Thailand	214	Bangladesh	216	Indonesia	236	Thailand	232	Philippines	240
Philippines	210	Thailand	170	Philippines	147	Indonesia	168	Indonesia	161
Bangladesh	145	Philippines	137	India	130	Philippines	160	Burma	154
Burma	125	Burma	104	Burma	114	Bangladesh	123	Malaysia	126
Pakistan	118	Pakistan	95	Bangladesh	104	Burma	95	Bangladesh	121
Egypt	71	Malaysia	75	Malaysia	92	Egypt	81	Pakistan	93
Malaysia	65	Sri Lanka	62	Sri Lanka	73	Pakistan	67	Sri Lanka	84
Turkey	51	Egypt	62	Pakistan	73	Sri Lanka	64	Egypt	73

Note: Net disbursement basis.

Soruce: Ministry of Foreign Affairs

Japan: roughly 70 percent of development aid was slated for Asia, while Africa, the Middle East and Latin America received approximately 10 percent each. It is no surprise, then, that China has been the single largest recipient of economic assistance since 1982, while the next three slots are filled by ASEAN countries (Thailand, the Philippines and Indonesia) (see Table 5). And while geopolitically important countries such as Pakistan and Egypt are included in the top-ten list, they are ranked eighth and tenth, respectively.

Since the negotiations on Peking's first loans in 1979, Japanese aid to China has skyrocketed. In 1985 alone it received $387.9 million. While this is partly due to political and strategic factors, the enormous potential of China's market is also an attraction. It is probably safe to assume that a combination of these factors has made Peking ASEAN's top competitor for aid.

Although Japan is committed to increased outlays in other regions of the world, officials admit there are problems. High per-capita income in some Middle East and Latin American countries poses obstacles to ODA eligibility status. As for Africa, Japan is hampered by lack of experience and vast cultural differences. Nonetheless, Tokyo is focusing on relieving poverty in Africa and is especially interested in agricultural development. In June 1985 Foreign Minister Abe proposed a "Green Revolution for Africa" to aid in reforestation, formulation of national development plans, infrastructure improvement, rural development reforms and improved conditions for small farmers (see JEI Report No. 34A, September 19, 1986). The severity of the crisis makes Africa the most likely number-two recipient of Japan's future aid flows.

Expansion of Aid Participation

According to Brooks and Orr,[3] Japan attempts to maintain approximately a 3:7 ratio of multilateral to bilateral ODA. While bilateral aid is preferred, by participating in multilateral efforts Tokyo can reach countries where bilateral projects are not feasible. The United Nations receives approximately one-third of Japan's total multilateral donations. Japan is the largest contributor to the Asian Development Bank as well as the second-largest in the African Development Bank and African Development Fund. It is also a major donor to the World Bank and its agencies, the Inter-American Development Bank and several international organizations in Asia, including the Asian Productivity Organization and the Southeast Asia Fisheries Development Center. (See JEI Report No. 37B, October 10, 1986, for a discussion of Japan's offer to boost its contributions to the International Monetary Fund and the International Development Agency, the World Bank's soft-loan arm.)

Official assistance is hardly the only form of aid, however. According to a 1985 report, over 200 non-governmental aid organizations (NGOs) exist in Japan. The government supports private aid efforts and hopes to collaborate more closely with the NGOs; in fact, these organizations received $40.7 million in government funding in 1984. Some examples follow:

- Japan Overseas Development Corp. - Provides on-the-job training in response to local requests; participates in overseas investment financing as well as import financing for joint venture products.

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[3] Brooks and Orr, op. cit., p. 334.

- International Development Center of Japan - Undertakes overseas studies of development-related issues and organizes courses for development planners and economists.

- OISCA Industrial Development Body - Sends more than 1,000 volunteer workers to developing countries and accepts trainees for technical instruction.

- Japan International Volunteer Center - Sends more than 1,000 volunteers abroad, especially to Southeast Asia.

- Asian Community Trust - Offers approximately Y11 million ($71,000 at Y155=$1.00) annually in financial assistance for development projects.

- Toyota Foundation - Provides financial assistance for development projects.

The current seven-year plan also includes more coordination between private and government activities. Special emphasis has been placed on the need to promote investment in the third world. While annual private investment in Asia, Latin America, the Middle East and Africa is greater than in 1973, flows to Africa and the Middle East have declined dramatically in recent years (see Table 6). Officials, recognizing the risks of investing in developing countries, have begun to implement special measures to stimulate investment. Not surprisingly, the major area of emphasis will be Asia (see JEI Report No. 32B, August 29, 1986).

Table 6: Japanese Foreign Direct Investment in Developing Regions, FY 1981-FY 1985

(in millions of dollars)

	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	As of March 31 1986
Asia	$3,338	$1,384	$1,847	$1,628	$1,435	$19,463
Latin America	1,181	1,503	1,878	2,290	2,616	15,636
Africa	573	489	364	326	172	3,369
Middle East	96	124	175	273	45	2,972

Source: Ministry of Finance

Saburo Okita, the former foreign minister, has also issued a proposal that resulted from a private study sponsored by the United Nations University of Tokyo and the World Institute for Development Economics Research. The plan, announced April 19, 1986, would be a Japanese "Marshall Plan" to recycle much of Japan's current account surplus -- nearly $50 billion in 1985 -- as loans to and investments in the developing world. The plan would involve tied-aid as an incentive to Japanese firms to support the program, as well as continued emphasis on export-led growth in Japan.

In a general sense, aid policies also include the Japanese public. The emphasis given to ODA expansion has widespread popular support, since aid is considered Japan's contribution -- as a peaceful country -- to the developing nations. In short, there seems to be a consensus among the bureaucracy, political parties, organized labor, the media, business and the public that Japan's ODA policies are worth the cost.

Problems

Despite Japan's efforts to increase aid flows, implementation difficulties will be hard to correct. While responsibility for formulating aid policy is primarily the domain of the Foreign Ministry, the issuance of direct loans requires the consensus of four ministries whose viewpoints often differ: Foreign Affairs, Finance, International Trade and Industry, and the Economic Planning Agency. This alone slows the bureaucratic process. Moreover, each year some funds remain undistributed because of inadequate infrastructure, shortages of qualified personnel and Japan's lack of expertise in some countries.

Japan has also been criticized because the interest rates on its loans and its repayment schedules have traditionally been tougher than those of other donors. Japanese officials say that "economic cooperation" is more effective when obligations and incentives are an integral part of an aid program. The problem has been exacerbated, however, by the recent appreciation of the yen. Thailand and Malaysia have already asked Japan to reschedule their yen-denominated loans in order to make it easier for them to service their debts. Japan is unwilling to do so, emphasizing that it does not raise interest rates when the yen is weak. Officials are also worried that concessions to ASEAN countries could lead to global demands for yen loan rescheduling.

Finally, Japan has come under fire by some domestic critics for its policy of granting aid on a request-only basis. At present development proposals cannot originate in government departments or agencies involved in aid policy. While the idea is based on the premise that the objectives of the recipients should be respected, it also allows Japanese companies to lobby recipient governments for project requests. This policy seems likely to change, however. The 1985 White Paper on Economic Cooperation recommended that Japan "make a careful study of the economic conditions and other factors in the recipient country." The first step toward change was taken recently when a survey mission was sent to Thailand to determine appropriate projects for ODA funds.

Prospects for Future Aid

The primary constraint facing Japan's aid-doubling goal is Tokyo's continued emphasis on fiscal austerity. Despite tight budgets, however, Japan stands a good chance of achieving its Third Medium-Term Target -- given favorable international circumstances. Specifically, the recent appreciation of the yen has made aid-doubling more likely. Because the yen remained relatively weak until September 1985, the effects of the appreciation will not be seen until the 1986 figures are compiled.

Attitudes concerning the role exchange rates should play in ODA targets vary significantly. Some Foreign Ministry officials have reportedly suggested that Tokyo should take advantage of the yen's rise by setting a shorter time limit for the $40 billion goal. Other officials argue that the government should avoid relying on exchange rate fluctuations and focus instead on real improvements in ODA contributions. In any event, current attempts to expand aid efforts as well as to effectively coordinate various types of assistance will continue; it is merely a question of how much expansion will occur.

Several proposals have been made with regard to the ways Japan can finance sustained increases in ODA. The Okita proposal to recycle Japan's current account surpluses to developing countries has already been mentioned. Some Foreign Ministry officials have suggested that Tokyo use windfall profits from the decrease in oil prices for ODA disbursements. Another advisory panel believes Tokyo could initiate an international cooperation tax, float a tax-free national bond or set up a lottery to gain additional aid funds. While none of these proposals has been officially adopted, the fact that attention is focused on ODA financing highlights Japan's commitment to its assistance programs.

Aid experts stress, however, that for Japan to meet its 1992 goal -- much less expand efforts beyond $40 billion, structural reforms are necessary. Without qualified personnel and better implementation facilities in recipient countries, Tokyo will be unable to distribute the funds already earmarked for development. Moreover, it will probably be necessary for Japan to expand ODA disbursements significantly in non-Asian regions, for even though countries such as India and the Philippines have vast needs, as one observer said, "There is only so much aid that Asia can absorb." As noted earlier, Japanese officials have publicly recognized the importance of both factors.

Conclusion

Japanese officials cite four additional problems that may impede their aid goals: the rising tide of protectionism in the industrialized countries; massive foreign debt in the developing countries; low export prices for primary commodities; and persistent food shortages and agricultural development problems in Africa. The broad scope of these concerns underscores the comprehensive nature of assistance policies. Japan's aid program is a response to domestic and international pressures to "do more" as a world power; it is also motivated by national economic and security concerns. As such, foreign aid will continue to be affected by Japan's political and economic relations with other industrialized countries, Tokyo's view of its own international role, and the success of government/private-sector cooperation in forming new ties with the developing countries.

For further information, contact Eileen Marie Doherty.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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Japanese Economy Remains Firm Despite Investment Slowdown

The deflationary effects of the yen's appreciation continue to slow Japan's economy. Although export volume rose in September, it had declined from year-earlier levels for six consecutive months. The drop in export earnings in turn has depressed business investment and raised unemployment, which reached 2.9 percent of the labor force in both July and August, a postwar high. Still, the economy is unlikely to plunge into recession since major sectors, including personal consumption spending and residential construction, remain steady.

The research arms of Japan's four major securities firms have forecast double-digit declines in the pre-tax profits of major Japanese companies in FY 1986, primarily due to their failure to pass on currency changes in the form of higher export prices in order to maintain market share abroad. While the overall profit decline is estimated at between 10.9 percent and 14.5 percent, there is a large gap between export-oriented industries and those benefiting from the yen's rise. A 30 percent-plus decline in pre-tax profits is projected for the manufacturing sector, in contrast to a 10-13 percent increase for nonmanufacturing companies. The forecasts assume an exchange rate in the Y150-Y163=$1.00 zone as well as a fourth cut in the Bank of Japan's official discount rate.

The expected decline in corporate profits is likely to lower the normal growth in capital investment from FY 1985's 11.7 percent jump and FY 1984's 10.7 percent increase. Major Japanese banks predict a modest 3.4 percent to 7.6 percent rise in investment in plant and equipment in fiscal 1986 and are even less optimistic about the following year (see Table). The electric power industry, which has gained windfall profits from cheaper oil, is expected to account for a significant portion of the increase. The government has forecast a 7.1 percent rise in business investment for the current fiscal year.

Forecasts of Private-Sector Plant and Equipment Investment

(percentage change from preceding year)

	Bank of Japan	Japan Development Bank	Industrial Bank of Japan	Long-Term Credit Bank of Japan	Nippon Credit Bank
Fiscal Year 1986					
All industry	3.4%	5.4%	7.6%	6.1%	6.8%
excluding electric power	-2.2	3.1	5.6	2.6	3.6
Manufacturing industry	-6.1	-3.6	-6.0	-5.1	-7.4
Nonmanufacturing industry	14.6	12.0	14.0	13.4	13.4
excluding electric power	9.8	10.3	13.3	11.1	12.1
Fiscal Year 1987					
All industry	n.a.	-0.7	-1.3	0.1	0.9
excluding electric power	n.a.	-0.3	-1.1	0.6	1.7
Manufacturing industry	n.a.	-10.6	-8.6	-15.4	-6.7
Nonmanufacturing industry	n.a.	2.1	1.5	2.6	3.7
excluding electric power	n.a.	5.0	3.1	5.3	7.1

Source: Nihon Keizai Shimbun, October 2, 1986.

Despite the slowdown in the manufacturing sector, housing construction and other nonmanufacturing activities continue to support the economy. Housing starts in July, for example, were up 13.5 percent from a year earlier. The benefits of the yen's appreciation, the fall in oil prices and lower interest rates will help sustain Japan's economic expansion, which began in March 1983. Bank of Japan governor Satoshi Sumita said he is waiting to see what effect these factors will have before deciding whether to lower interest rates again. Moreover, the present interest rate gap between the United States and Japan is about right, Mr. Sumita said, given this country's large financing needs.

Many economists, though, remain less optimistic about Japan's economic prospects. The International Monetary Fund predicts that inflation-adjusted growth will slow from 4.5 percent in 1985 to 2.6 percent this year. And Sumitomo Bank, Ltd. recently lowered its real growth forecast for FY 1986 by 0.5 percentage point to 2 percent. Tokyo, though, remains committed to its outlook of 4 percent real growth in FY 1986, hoping for a big boost from the economic stimulus package announced September 19. Work on the supplementary budget to fund the package is expected to be completed October 24 and will be submitted to the Diet late this month.

Randall S. Jones

Attention Focuses On Japan's Tax System

Spurred by the passage of a sweeping U.S. tax reform package, Japan is moving toward an equally significant restructuring of its tax system. In preparation for the opening of the Diet's next regular session in December, the government's Tax System Council has been putting together a final report on tax reform. Bits and pieces of the final plan are coming to light as intense debates within the council and around the nation continue to evolve. To complicate the tax writers' problems, a personal income-tax cut has been proposed and a big supplementary FY 1986 budget is expected to be approved shortly, increasing fiscal pressures.

The Japanese have several long-standing complaints about the tax system. While salaried workers have income taxes deducted at the source, self-employed individuals report their own income and calculate their tax liability, leading to significant tax avoidance by farmers and small businesses. Big business, on the other hand, has constantly argued that Japan's corporate income tax rate of 43.3 percent (33.3 percent on income distributed as dividends) is high by international standards. Since local taxes add almost another 10 percent, corporations see half of their profits go to the government's coffers. Finally, regulations that grant tax-free status to interest on savings of up to Y14 million ($90,300 at Y155=$1.00) are widely abused by individuals who open more than the single account permitted by law, engendering calls for reform or abolition of the exemption.

Since September, a year after Prime Minister Yasuhiro Nakasone charged the Tax System Council with drawing up a tax reform package, the outlines of the plan have been aired in public. Personal and corporate income-tax rates would be slashed. The top bracket for individuals would drop from 70 percent to 50 percent. Including local taxes, the top wage earners would face a marginal rate of 60 to 70 percent. A reduction in the number of brackets from the current 15 is also contemplated to make pay raises more attractive by reducing the progressiveness of the rates.

A single rate of 35 percent is being suggested to replace the two-tier corporate income-tax structure. The Economic Planning Agency calculates that the reduction could inflate capital spending by as much as 8 percent annually over the next four years. The proposal has certainly received an enthusiastic reception from the private sector.

To pay for these reductions, one simple and several complex ideas have been circulated. The most popular of these proposals would alter the income reporting regulations so that self-employed taxpayers would find it more difficult to avoid taxes. The possibility of one or more indirect taxes, though, has generated some debate. During the 1986 Diet elections, Mr. Nakasone ruled out a European-style value-added tax. The Tax System Council has raised three alternatives: broadening the coverage of the commodity tax from the current 85 items to most final goods (excluding food as well as raw materials, machinery and goods used in manufacturing); instituting a single tax on products and services between the production and consumption stages (except for food, social security payments and inter-firm transactions); and imposing a tax on businesses based on the difference between their tax liability using sales data and the taxes paid on materials consumed in the manufacturing process (the so-called Japanese-style value-added tax). The indirect tax issue has split normally cohesive groups. Not surprisingly, business groups oppose one option and support others according to whether the tax ax will fall on them or on someone else. Political parties have also been divided by the issue, leading to more debate.

This conflict pales, however, in comparison to the discussion over the fate of the tax-free savings system (maruyu). Not only are small savers up in arms, but the Ministry of Posts and Telecommunications, which administers the Postal Savings System, is also lobbying hard to retain the tax exemption. On the other hand, the Ministry of Finance and the commercial banks and securities firms favor significant reform -- if not elimination -- of the system, the former because of the revenue-raising potential of an overhaul and the latter because it will eliminate a privileged competitor (the Postal Savings System). The issue has proven so sensitive that many previous attempts at reform have failed; it is not clear if Mr. Nakasone can succeed.

At any rate, the Tax System Council's final report will not be the last word on tax reform. With so many actors and so many interests participating, it is still unclear what legislation will be introduced in the upcoming regular Diet session for fiscal 1987 implementation.

Jon Choy

Stronger Yen Pushing Down Import Prices In Japan

The effect of the yen's 56 percent appreciation against the dollar since late September 1985 has at last managed to filter down through the many layers of the Japanese distribution system. An April government survey showed just half of the items checked were selling at lower retail prices, despite almost across-the-board declines in import prices (see JEI Report No. 23B, June 20, 1986). But a more recent survey indicated that retail prices on three-fourths of the items in the sample had been reduced. In addition, many Japanese retailers are strengthening their overseas buying operations to capitalize on the yen's higher value.

According to the Ministry of International Trade and Industry, of 41 items recently surveyed, 39 cost less to import and 33 sold at lower retail prices. As was the case in the earlier survey, retail prices fell more sharply than import prices in some cases, and less in others (see Table). The disparity is probably due to the time lags built into the system as well as varied pricing policy decisions by distributors and retailers. For example, retail prices of well-known brandname goods did not decline even though import prices fell, according to MITI. This may reflect the retailer's decision that price is not an important factor in sales of these popular products. In fact, for some premium foreign goods, price cuts would probably be counterproductive, destroying the cachet of exclusivity.

Selected Changes in Import and Retail Prices, June 1986*

(in yen and percentage change)

	Import Price Change	Retail Price Change	Percentage Change	Retail Price
Tuna (per kg)	Y-237	Y-300	-7.1%	Y3,930
Shrimp (per kg)	-577	-420	-8.4	4,590
Lemons (per kg)	-245	-899	-71.3	362
Bananas (per kg)	-9	13	5.0	274
Cacao beans (per kg)	-185	-10	-0.4	2,460
Whiskey (average grade)	-123 to -147	0 to -1,350	0 to -32.5	2,650 to 4,150
Wine (American)	-96 to -219	0 to -500	0 to -25.0	900 to 1,800
Records	-238	-175	-8.1	1,990
Golf club sets	-8,670	-32,000	-20.0	128,000
Watches	-3,432	0	0.0	224,000
Handbags	-1,852	-3,000	-7.0	40,000
Fountain pens	-1,332	0	0.0	60,000
Photographic film (roll)	0	0	0.0	530
Perfume (bottle)	0	0	0.0	15,000

*Changes calculated using August 1985 base prices.

Source: Ministry of International Trade and Industry

Although the retail price reductions are probably due to the normal -- but slow -- process of price changes working their way through the distribution network, Tokyo has been doing its best to jawbone retailers into passing on the benefits of the stronger yen. Prime Minister Yasuhiro Nakasone, who expressed concern over the sluggish reaction of retail prices when the first survey was conducted, instructed the cabinet to find ways to improve the situation. Forthwith, MITI, the Economic Planning Agency and others began to complain that consumers were not benefiting quickly enough. The Japan Fair Trade Commission even went so far as to initiate a study as to why retail prices were not changing in reaction to import price cuts.

Retailers themselves are beginning to make adjustments in light of what is apparently a permanent appreciation of the yen. Several major department stores have reorganized their foreign products purchasing departments into separate trading companies to take advantage of tax laws and more vigorously search for products to import. Other firms have added a purchasing office to their overseas stores to bolster import activities. A boom has gripped the trading business as more distributors are finding it worthwhile to open their own overseas offices. Finally, Tokyo continues to support these import drives with overseas and domestic programs. MITI has designated October, for example, as import promotion month.

Jon Choy

Japan's Trade Surplus With Korea And Taiwan Rises

The realignment of exchange rates during the past year has boosted the economies of Asia's newly industrialized countries by making their exports more competitive in world markets. In the year following the September 1985 Group of Five agreement, the yen appreciated 52 percent and 45 percent against the currencies of Korea and Taiwan, respectively, which are essentially linked to the dollar. The currency changes are a major reason for the 25 percent rise in Korea's aggregate exports during the first eight months of 1986. This export boom is expected to fuel real economic growth of about 9.5 percent and a record trade surplus of $2 billion in 1986. Similarly, Taiwan's overall exports in the June-August period were up 34 percent from a year earlier.

The appreciation of the yen has enabled Korea and Taiwan, Japan's sixth- and tenth-largest trading partners, respectively (based on two-way trade), to increase their sales to Japan during the first nine months of 1986 (see Table), in contrast to the overall decline in Japanese imports. Manufactured goods accounted for most of the increased purchases; imports of Korean textiles and steel in August, for example, were up 30 percent and 40 percent from a year earlier.

Japan's Trade with Korea and Taiwan

(in millions of dollars)

	1983	1984	1985	January-September 1985	January-September 1986
Exports					
Korea	$6,004	$7,227	$7,097	$5,026	$7,568
Taiwan	5,086	5,986	5,025	3,694	5,391
Imports					
Korea	3,365	4,213	4,092	2,958	3,544
Taiwan	2,622	3,204	3,386	2,471	3,198

Source: Japan Tariff Association

Exports to Korea and Taiwan rose 50.6 percent and 45.9 percent, respectively, in dollar terms during the January-September period, compared to a 21.6 percent increase in total Japanese exports. The sharp rise in shipments reflects both the J-curve effect, which makes a given quantity of exports more expensive in dollar terms, and the rapid pace of economic activity in the two developing countries, which increases their import volume. The rise in deliveries of machinery and equipment was especially sharp; shipments of office machinery to Taiwan and Korea in August 1986 were more than double the same month in 1985.

The changes in trade flows are exacerbating trade disputes, particularly between Japan and Korea. Japan's surplus with Korea, which totaled $3.4 billion during the January-September period, may reach $6 billion this year. Since the normalization of relations in 1965, Korea has accumulated $32.9 billion in trade deficits with Japan, a figure equivalent to 70 percent of its foreign debt. To reduce this imbalance, Seoul recently instructed domestic producers to find European and U.S. suppliers of 30 industrial, electronic and chemical products currently imported from Japan. But given Korean industry's dependence on Japanese capital and intermediate goods, it will be difficult to change sources of supply quickly. For example, half of the components of Korean-made video cassette recorders come from Japan.

Randall S. Jones

Trade Measures Proposed In Final Days Of 99th Congress

The adjournment date of the 99th Congress was repeatedly postponed as legislators concluded work on the appropriations resolution, budget reconciliation, drug legislation and immigration reform acts at an almost frantic pace. Throughout the rush, however, trade-conscious members attempted to push through at least some trade measures. Some of these, including "Buy America" provisions for machine tools and ball bearings (see article in this issue) as well as a Customs user fee, were enacted. Others -- for example, a miscellaneous tariff bill and a "Buy America" provision for oil rigs -- failed to achieve Senate approval.

U.S. trading partners watched the progress of a miscellaneous tariff bill (HR 5686) with great interest. The proposal, which would have affected tariffs on 83 categories of items as well as requirements for proceedings under Section 337 of the 1930 Tariff Act (patent infringement and other unfair trade practices), passed the House October 14 (see JEI Report No. 38B, October 17, 1986). Despite House appeals to the Senate, the measure never made it to a vote in the upper chamber. When a unanimous consent agreement was proposed to bring a revised version of the bill to a vote -- including deleting provisions concerning Section 337 cases and deleting tariff changes related to television apparatus and parts, watches and watch components -- the Senate refused to accept the bill without having an opportunity to introduce amendments.

The miscellaneous tariff bill would probably have passed the Senate if the legislators had been willing to use precious time for debate. However, by the week of October 13, pressures to adjourn had mounted. Legislators were anxiously watching their campaign opportunities slip away. Moreover, although

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JAPANESE DEFENSE: UNDERPINNINGS AND CONSTRAINTS

Summary

The essentials of Japan's defense policies are widely known in both Japan and the United States. Even the man on the street is aware that Japan restricts its total annual defense budget to an amount roughly equal to one percent of its gross national product. After that, however, distinctions become blurred. What is often described as a "constitutional" restriction on defense policies, for example, is more often a policy decision established by the cabinet that has never been legislated in any form and theoretically is subject to change. The objective of this brief is to help provide some of the distinctions between "policies" and more fundamental restrictions and how they merge to form the underlying foundation for present-day policies.

The Framework of Japan's Defense Policies

No aspect of Japan's defense policies is better known than its "peace constitution." The circumstances surrounding the adoption of Article IX are still in dispute by scholars and policymakers in both Japan and the United States. While the debate over whether the renunciation of war was imposed on Japan by Occupation authorities or willingly adopted by the Japanese government has some bearing on overall defense policy discussions, it is sufficient for the purposes of this analysis simply to outline its role in the overall formation of present-day policies. Article IX is brief and concise:

> Aspiring sincerely to an international peace based on justice and order, the Japanese people forever renounce war as a sovereign right of the nation and the threat or use of force as a means of settling international disputes.
>
> In order to accomplish the aim of the preceding paragraph, land, sea, and air forces, as well as other war potential, will never be maintained. The right of belligerency of the state will not be recognized.

It is important to note that these two paragraphs are the only bona fide constitutional restrictions on Japan's defense. The key to present-day defense policies lies in understanding the government's interpretations of Article IX in light of domestic public support and the international climate. Very few of the policies constructed on the foundation of Article IX have been legislated since the 1954 laws establishing the Self-Defense Forces and the Japan Defense Agency were passed; rather, they result from a series of cabinet decisions over the last 30 years.

To date, government policies -- including the establishment of the Self-Defense Forces and cooperation with the United States -- have survived a series of legal challenges. A 1955 case resulted in a Supreme Court ruling four years later that Article IX did not exclude the right to self-defense; the right to take "appropriate measures" to assure self-defense (that is, establishing a military force to protect the country); or the right of the government to enter into security arrangements with other countries. (That interpretation was also alluded to by the peace and security treaties between the United States and Japan. Although the 1960 Mutual Security Treaty, which replaced the 1951 Security Treaty, omitted the references to self-defense rights, this principle has remained fundamental to defense policymaking.) District and Supreme Court decisions in 1976 and 1977 reaffirmed and in some respects expanded on these principles.

Japanese cabinets in subsequent decades have implemented a variety of supporting policies that have been deemed to be consistent with the spirit and letter of Article IX, primarily in the form of restrictions on the SDF and the Japan Defense Agency. More often than not, Japanese defense policies have been articulated in terms of what cannot be done. Included among these doctrines are the following:

- No overseas troop deployments - A Diet upper house resolution in 1954 helped establish this principle, as did provisions in the Self-Defense Forces law. Although there is debate over the constitutionality and/or desirability of deploying SDF forces for United Nations peacekeeping operations, the law establishing the SDF was once interpreted as prohibiting such operations. The measure was amended in 1981 to prohibit deployment to countries where the SDF could be used as a "measure of force," paving the way for policy to take over where legal restrictions once stood. Although it may now be legally permissible to send SDF personnel abroad as part of a U.N. peacekeeping or observation force, current policy stipulates that it is not allowed.

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This position has been reaffirmed in successive sessions of the Diet in interpellations between Diet members and cabinet officials. Given the present climate, there appears little likelihood of a policy adjustment or legislative amendment to existing statutes to specifically allow SDF participation in U.N. forces. Consequently, when policymakers declare that overseas deployments -- even as part of U.N. observation teams -- are "unconstitutional," what they in fact meant prior to 1981 was that such deployments contravened Japanese laws, enacted in part to reflect Article IX. Since 1981 it has been a matter of government policy. There are exceptions to this rule. Where there is no danger of SDF personnel becoming involved in conflict situations, they are allowed to travel abroad for training purposes; Maritime Self-Defense Force vessels have made a number of overseas calls; and military personnel do serve as attaches in Japanese embassies.

- No "offensive" weapons - As the constitution prohibits "warmaking potential," the bind facing policymakers is in deciding what constitutes that potential. The government maintains that weapons systems manufactured, imported or deployed must be of an essentially defensive nature to be consistent with this provision. How, then, to define defensive versus offensive weapons? This is a matter that has been painfully established over the years in cabinet discussions and Diet debates, and is more than just semantics since the decisions directly affect Japan's defense capabilities.

As time has separated modern Japan from its wartime experiences and the nature of potential threats to its security has changed, the definition -- or, more properly, the perception -- of defensive systems has been adjusted. For example, when F-4 fighters were originally introduced to the SDF, the Japan Defense Agency ordered the planes without in-flight refueling capabilities, working under the premise that without this capacity, the range of the planes would be restricted essentially to Japan and therefore would not constitute a threat to other countries. Thus they could not be considered offensive.

Time and modern technological developments have changed the situation. Japan has assumed the goal of defending its sealanes to a distance of 1,000 nautical miles, well beyond the range of even the more advanced F-15s without refueling. Consequently, the government is considering proposals to install extra fuel tanks on the F-4s to extend their range and equip them for sealane defense.

The increasing sophistication and quantity of Soviet deployments in Asia have also persuaded Japanese policymakers to upgrade SDF capabilities. Thus the emphasis on domestic production of the SSM-1 surface-to-surface missile, a Japanese-designed system with a distance of 80 to 100 kilometers. When deployed on Japanese maritime vessels, the missile will have the capability to strike targets well beyond Japanese territorial waters, a quantum leap both in technological and policy terms. It is important to remember that at one time, policymakers felt that Japan's right to self-defense meant it could act only if foreign troops literally breached Japan's shores. This position has been modified somewhat over the years.

During the course of postwar deliberations, successive governments have underscored the concept of sustaining a defense capability that would represent the minimum necessary to preserve Japanese territorial integrity. Popularized by the Hatoyama government in 1954, this terminology has become a standard element of Japanese defense policy planning, appearing regularly in the annual defense white papers. It is in the context of the defensive versus offensive weapons debate that the notion of minimum sustainable defense is important.

- No collective security agreements - Government policies maintain that although Japan has the legal right to enter into collective security arrangements -- the 1959 Supreme Court ruling cited earlier affirmed that principle -- it is a matter of policy that the minimum level of defense stance limits that right. Thus, a security treaty is permissible within the scope of present policies, but it is highly unlikely that a more encompassing arrangement for Japan -- something like the North Atlantic Treaty Organization -- would be. A certain element of flexibility has been introduced to allow Japanese participation in RIMPAC exercises, which include armed forces from Japan, the United States and other Pacific nations, but the general policy remains intact.

In justifying the security treaty with the United States, Japanese policymakers state that it is consistent with standing policies because it helps maintain minimum self-defense capabilities. Moreover, they note, the agreement is not fully reciprocal: it does not obligate Japan to defend the United States if it is attacked (although Prime Minister Yasuhiro Nakasone recently committed Japan to the defense of U.S. vessels deployed to defend Japan if they were attacked, even in international waters).

- No draft - The political rationale for this position is self-evident. Furthermore, many Japanese constitutional authorities agree that Article XVIII -- prohibition of involuntary servitude -- absolutely forbids the institution of a military draft.

The Nuclear Prohibition

Equally famous are Japan's non-nuclear principles -- the restrictions against possessing, manufacturing or "introducing" nuclear weapons -- issued by the Sato government in 1968. Nuclear opponents sought assurances that Japan would preserve a place in the world as a moral opponent of the proliferation of these systems. As the only victim of a nuclear bomb, Japan could serve as a beacon to world peace, these forces argued, if it forever renounced these weapons. Practical considerations were also present. Japan's regional neighbors have been suspicious of its growing military strength -- despite its determinedly defensive nature -- and its anti-nuclear stance helped reassure them of Japan's peaceful intentions.

These principles have come under stress in light of the realities of the U.S. "nuclear umbrella." The United States guarantees Japan's strategic security through extension of its nuclear forces, and some U.S. naval vessels in the Pacific presumably would have to carry nuclear weapons in order to assure the credibility of that guarantee.

The United States steadfastly has maintained a policy of no confirmation or denial of nuclear deployments. That is, weapons may or may not be deployed on certain vessels or in certain geographic regions, but the Department of Defense is mute on the subject. This enables the United States to maximize its nuclear deterrence capability by allowing it to disguise the precise location of its strategic systems. The Japanese government has accepted this position. Tokyo contends that the 1960 Mutual Security Treaty requires prior consultation if the United States seeks to deploy forces in Japan. This, the government argues, includes nuclear forces. Since no consultations have been initiated, it is presumed that no nuclear weapons have been "introduced."

This understanding has maintained security and preserved Japanese policy for 40 years. Many U.S. defense analysts argue further that it has in fact contributed to nuclear stability, since the only other alternative to "no confirmation/denial" is massive nuclear deployment, an unacceptable option in both military and economic terms. Anti-nuclear forces in Japan reject this stance and exploit every opportunity to embarrass the government and gain leverage in their campaigns. They were particularly outraged in the early 1980s when former U.S. ambassador to Japan Edwin Reischauer declared that nuclear weapons had been in and about Japan.

That crisis passed, however, and the status quo remains, although Japanese opinion polls suggest some public skepticism. The United States extends its umbrella, and Japan officially expresses satisfaction that its principles are intact.

Interestingly, a 1983 study by Robert F. Reed[1] notes that the 1970 defense white paper (prepared under the supervision of then-JDA director general Nakasone) suggested that possession of tactical nuclear weapons was consistent with the non-nuclear principles. By the same token, nuclear depth charges have been proposed for the Maritime Self-Defense Forces for anti-submarine warfare.

As a practical matter, however, proposals to consider such steps would meet with intense public opposition. Furthermore, Japan's atomic energy law, passed in 1955, calls for utilization of nuclear power for peaceful uses only. Finally, Japan is a signatory to the Nuclear Nonproliferation Treaty, adding both moral and legal restrictions to any utilization of nuclear weapons systems. Nevertheless, it is important to note again that these policy guidelines have been established over the years primarily through cabinet-level discussions and have never been codified by the Diet, although the principles were reaffirmed by a Diet resolution in 1971 and by any number of government officials since that time.

Weapons Export Ban

This is another policy that has taken firm root in Japanese defense considerations. While early postwar bills established the trend toward the current ban on weapons exports, the present position is the result of cabinet decisions and not constitutional provisions. Although there has been, and presumably will be, pressure from arms manufacturers to loosen the ban, it is safe to say that for the near future, there will be no change.

[1] Robert F. Reed, The U.S.-Japan Alliance: Sharing the Burden of Defense (Washington, D.C.: National Defense University Press, 1983), p. 26.

It was the Sato government that instituted the broad elements of Japan's weapons export ban. In 1967 the government determined that Japanese manufacturers could not export weapons to communist countries, nations involved in conflicts or on the verge of armed disputes, or countries on U.N. embargo lists. The Miki government reinforced those policies in 1976, extending the ban to weapons technology and production methods. The problem in enforcing the policies comes in deciding what constitutes a weapon. For example, although the T-2 trainer aircraft manufactured by domestic firms for the Japan Defense Agency is used by the Self-Defense Forces, it is not subject to the export ban since it carries no armaments. Reinhard Drifte, assistant director for regional security studies at the International Institute for Strategic Studies, recently wrote[2] that numerous ambiguities in the present policy permit, for example, the display of fully armed, co-produced helicopters at the Paris Air Show and exports of jeeps to the Nicaraguan army. Furthermore, the U.S. Arms Control and Disarmament Agency listed certain Japanese dual-use exports as arms exports in its World Military Expenditures and Arms Transfers.[3]

These examples demonstrate the difficulty of enforcing a strict ban on arms exports. Increasingly, as DOD has noted, Japan's most significant security and defense contributions may be in the dual-use category, since so much of the country's research and development is initiated for commercial purposes yet has potential military application because of its sophistication. Furthermore, there remains the problem of exported products ultimately used for military purposes -- the above-mentioned jeep case, for example -- as opposed to exports that clearly fall into the weapons category -- complete bombs, for instance.

Peaceful Uses of Space

With the emergence of the controversy over the Strategic Defense Initiative, Japan's policies regarding the peaceful use of space have attracted considerable attention. The first Diet resolution on space utilization was approved by the lower house on May 9, 1969, stipulating that launch systems "shall be confined to peaceful purposes only and shall be carried out to contribute to the progress of science, the improvement of the nation's living standards and the welfare of human society."

With the growing desire of the SDF to utilize satellites for a variety of communications and intelligence purposes, the government clarified its understanding of that resolution before the lower house budget committee on February 6, 1985. The position adopted at that time stated that the phrase "for peaceful purposes only" was construed as "disapproval of direct use by the Self-Defense Forces of any satellite as a [lethal] or destructive weapon." MSDF's access to the U.S. Fleetsat telecommunications satellite was justified on the grounds that the system's functions were similar to the telecommunications -- as distinct from the military -- functions of other systems commonly utilized by Japan, including Intelsat systems, Inmarsat (International Maritime Telecommunications System) and its own current generation of communications satellites, used by the SDF for unclassified communications. The government has further taken the stance that participation in SDI research is consistent with established policies.

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[2] Reinhard Drifte, Arms Production in Japan: The Military Applications of Civilian Technology (Boulder, Colorado: Westview Press, Inc., 1986), Chapter 6.

[3] U.S. Arms Control and Disarmament Agency, World Military Expenditures and Arms Transfers 1985 (Washington, D.C.: Government Printing Office, 1985).

Implementation of the Policies

The legal framework for the nuts and bolts conduct of Japan's policies is outlined in the 1954 legislation establishing the Self-Defense Forces and the Japan Defense Agency. Furthermore, two sets of broad policy guidelines direct present-day policies: the 1976 National Defense Program Outline and the periodic five-year procurement programs.

While the provisions of the SDF and JDA legislation are too extensive to detail completely here, the essential elements are worth examining. One of the primary purposes of the legislation, of course, is to establish civilian control over the military. There are also restrictions that have limited to a significant degree the power of the prime minister to initiate and implement defense policies. Most significant of these is the establishment of the National Defense Council, a consultative body consisting of the prime minister, the director general of the defense agency, and certain other key ministers. The prime minister must report to and/or consult with the NDC in a number of areas before taking certain actions, including:

- Decisions involving the Defense Outline;
- The "coordination of industrial production and other matters relating to defense planning;"
- Decisions regarding the mobilization of the Self-Defense Forces; and
- "Other matters related to national defense that the prime minister recognizes as necessary to be discussed."

This vague yet comprehensive definition of matters subject to the NDC's review significantly limits the power of the prime minister to conduct an independent defense strategy. Supporters of the present arrangement, of course, contend that such a structure is necessary from a number of perspectives, including assurance of civilian control, prevention of a resurgence of militarism and the preservation of institutional limitations on Japan's defense to reassure Asian neighbors of the country's peaceful intentions. Critics say that requiring a council to approve decisions as fundamental as troop deployments in times of emergency is too cumbersome. Indeed, the Nakasone government currently is seeking suitable alternatives.

In addition, a number of statutes restrict the discretionary authority of the SDF and JDA, even in times of emergencies. For example, if Japan were invaded by a hostile force, it is questionable whether the prime minister's office would have the legal authority to allow effective deployment of SDF units. Numerous laws and regulations limit movements of the SDF. Many of these restrictions have been under examination by special task forces since the

1970s, and the cabinet is nearing a decision on the details of special emergency legislation to rectify the problems. Given their already highly controversial nature, the studies conducted have operated under grounds rules making any consideration of restricting civil liberties -- such as restrictions on freedom of speech during military conflicts or national emergencies -- off-limits.

The 1976 Outline

The JDA and SDF enabling legislation set the ground rules for formation of policies; the cabinet has done the rest. The document guiding present-day defense policies is the 1976 defense outline mentioned earlier. Approved by the Miki cabinet, the outline was sought by defense proponents who felt that without a firm articulation of policies, the SDF lacked direction and effectiveness. It was opposed by elements suspicious of the military who feared that such a step would revive militarism in the country. A statement of principles, they felt, implied certain commitments. Nevertheless, the National Defense Program Outline was approved October 29, 1976 to achieve the "maintenance of a full surveillance posture in peacetime and the ability to cope effectively with situations up to the point of limited and small-scale aggression." Among its assumptions of the international situation necessitating Japan's self-defense program are the following:

- The major power blocs will continue a dialogue toward improving relations and reducing the threat of nuclear war.

- Despite this trend, regional instability will remain and the international situation will continue to be fluid.

- An equilibrium exists among the United States, China and the Soviet Union in the area around Japan.

- There is little possibility of a full-scale conflict between East and West due to the military balance, including the nuclear balance.

- That while the possibility of regional conflict cannot be dismissed, the U.S.-Japan security arrangement helps maintain international stability and prevents full-scale aggression against Japan.

The outline then details the force levels to be achieved and maintained to prevent various forms of direct and indirect aggression (see Appendix).

Through five-year procurement programs -- a pattern established prior to the adoption of the outline -- the government began to meet its long-term objectives. The present program -- the first to have the status of an official government program as opposed to being simply a target proposal -- took effect April 1, 1986 and will run to March 31, 1991.

To satisfy defense critics concerned about the implications of defining precise procurement goals, the Miki cabinet also adopted the now-famous restriction limiting total annual defense spending to a maximum of one percent of Japan's gross national product. Although the limit was adopted on a "temporary" basis, the emotional climate has grown so intense that the slightest challenge to the limit is a matter of front-page attention in Japanese dailies.

It is significant that most of the broad goals of the outline have been satisfied. Much of the direction of recent defense procurement policies has been to institute qualitative improvements in the levels of readiness described in the outline. However, the 1986 defense white paper addressed the issue of quantitative changes, although the annual report also stated that the government is not considering revision of the 1976 outline. Such discussions, coupled with the pressures of maintaining the present defense structure, have led to suggestions by some Japanese defense analysts that the 1976 outline itself -- and the accompanying one percent limit -- be examined in light of current realities and future needs. The Nakasone government reaffirmed the one percent policy in September 1985, but slower-than-anticipated economic growth could produce a situation where defense spending in fact exceeds one percent of GNP.

This debate is also significant in light of the additional burden assumed by the Suzuki government in May 1981: the promise to expand air defense and protect Japan's sealanes to a distance of 1,000 nautical miles. Revision advocates argue that the very assumptions of the 1976 outline are out of date and that procurement must be expanded to adapt not only to the realities of the growing Soviet buildup but also to the responsibilities implied by the 1981 sealane commitment. It is possible that this debate will emerge in early 1987 as the Diet examines the new defense budget.

The point of overriding importance is that the five-year programs, the concepts contained in the 1976 outline and the one percent restriction are all intertwined. Much of the sensitivity of the defense issue in Japan may have faded because of the carefully constructed bargains struck at the policymaking level over the last 10 years. Diet approval has come in the form of its approval of the annual defense budget. Altering one element of the structure could precipitate challenges to other elements and have significant potential for controversy.

International Agreements

Japan's defense interaction with other nations is increasing, but its relationship with the United States remains primary. The United States is the only country with which Japan maintains a formal defense-related agreement, outside of international treaties such as the nonproliferation agreement.

The fundamental element of the relationship is the Mutual Cooperation and Security Treaty of 1960. Replacing the Security Treaty of 1951, the present agreement, which is in force unless either party gives a one-year termination notice, provides for actions by either party against aggression in Japanese territory or possessions. Prime Minister Nakasone has, as noted, extended Japan's commitment under the treaty in a policy declaration during Diet interpellation that Japan could respond to an attack on U.S. vessels deployed to protect Japan even if they were in international waters. The treaty also provides the legal basis for U.S. bases in Japan (Article VI). An exchange of notes for implementing Article VI included the now-famous prior consultation clauses that give Japan considerable influence over U.S. deployment of American forces stationed in Japan.

The Mutual Defense Assistance Agreement of 1954 established the legal basis for providing equipment and technology to Japan. With Japan's growing role as a provider of technology, the agreement is also important in developing the rationale for technology flows back to the United States to reciprocate, in a sense, for years of technological imports by Japan, many of which have had distinct commercial applications according to one U.S. government report.

Conclusion

The structure of Japanese defense policy is an intricate one. A series of cabinet decisions and legislative actions have produced a well-defined yet delicately balanced set of guidelines that direct the formation of the country's policies. Because of the special burdens imposed by the country's experience of the 1930s and 1940s, any modification of this structure assumes even more profound implications. This helps explain, in part, the country's methodical approach toward defense issues and the frustration on the part of many of Japan's allies at what they perceive as footdragging in a key area. Nevertheless, it also explains why Japan has been able to make significant strides in defense with a minimum of public outcry.

For further information, contact Michael W. Chinworth.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix: Force Levels Stipulated by 1976 National Defense Program Outline

Classification	Level Stipulated in NDPO	Achieved FY 1985
Ground Self-Defense Forces		
Authorized personnel	180,000	180,000
Units deployed regionally in peacetime	12 divisions 2 composite brigades	12 divisions 2 composite brigades
Mobile operational units	1 armored division 1 artillery brigade 1 airborne brigade 1 training brigade 1 helicopter brigade	1 armored division 1 artillery brigade 1 airborne brigade 1 training brigade 1 helicopter brigade
Low-altitude surface-to-air missile units	8 anti-aircraft artillery groups	8 anti-aircraft artillery groups
Maritime Self-Defense Forces		
Anti-submarine surface ship units (for mobile operations)	4 escort flotillas	4 escort flotillas
Anti-submarine surface ship units (regional district units)	10 divisions	10 divisions
Submarine units	6 divisions	6 divisions
Minesweeping units	2 flotillas	2 flotillas
Land-based anti-submarine aircraft units	16 squadrons	14 squadrons
Anti-submarine surface ships	60 ships	60 ships
Submarines	16	15
Combat aricraft	220	190
Air Self-Defense Forces		
Aircraft control and warning units	28 groups	28 groups
Interceptor units	10 squadrons	10 squadrons
Support fighter units	3 squadrons	3 squadrons
Air reconnaissance units	1 squadron	1 squadron
Air transport units	3 squadrons	3 squadrons
Early warning units	1 squadrons	1 squadrons
High altitude surface-to-surface air missile units	6 groups	6 groups
Combat aircraft	430	400

Source: Japan Defense Agency, Defense of Japan, 1985.